Identifying a Personal Property Lease Under the UCC*

CORINNE COOPER**

I. INTRODUCTION

There is a certain mysticism in the process of analyzing a transaction for its true nature. A lawyer may, at first blush, identify a transaction as a "property" or "contract" problem. Upon deeper thought, she may discover that these categories are at best vague estimates of the legal rights associated with the transaction, with elements arbitrarily identified with one or another category. Indeed, it is the very nature of law that these distinctions are not easily articulated. Perhaps that is why lawyers return repeatedly to that truism of legal analysis, "I can't define it, '[b]ut I know it when I see it.'"[1]

By saying that "we know it when we see it," lawyers are doing more than obscuring an otherwise objective process. An understanding which is in part educated and in part intuitive permits a differentiation among related ideas, even when the lawyer is not capable of articulating a simple rule. Even without the benefit of a neatly expressed rule, the distinctions resulting from this process may provide a meaningful standard, but only if the standard can be applied consistently to similar transactions.

For example, suppose two participants in a game take twenty cards of an identical blue color. They agree that ten of the cards will be considered "blue" and ten of the cards will be considered "red." In order to provide consistency, they identify the red cards with a tiny letter "R" in a corner. Then they play the game, the results of which are determined by the order of blue and red cards dealt. A casual observer of this game might suffer confusion, protesting that all of the cards are in fact blue, and that there is no difference between the color of the blue cards and the red cards, but to the players this objection is irrelevant. The distinction has been made, and applied consistently with predictable results, so that the goals of the participants are served. The standard chosen in this case does not rely upon the inherent qualities of the cards, but only upon the arbitrary distinction applied by the players.

 Originally published at 49 OHIO ST. L.J. 195 1988.

** Associate Professor of Law, University of Missouri-Kansas City School of Law. B.A., 1975, J.D. 1978, University of Arizona. This Article would not have been possible without the kind assistance of many people. For their review and very helpful comments, I am grateful to Professor Amelia Boss of Rutgers University, Professor Fred Miller of the University of Oklahoma, and Professor William Woodward of Temple University. Because he took the time to teach me the right answer when I was wrong, I am grateful to Professor Charles Mooney of the University of Pennsylvania. For her uncompromising accuracy, I thank my research assistant, Terry Milne, UMKC Law School Class of 1987. And because she never raised her voice when I preempted her use of her computer to edit this Article, I thank my patient secretary, Valerie Brown.

1. Jacobellis v. Ohio, 378 U.S. 184, 197 (1964) (Stewart, J., concurring). It is the elusive nature of legal analysis that makes teaching law such a rewarding experience for the teacher, and such a frustrating process for students. It is only by dealing repeatedly with concepts, using hypotheticals to pinpoint distinctions, deconstructing these distinctions, and returning to basic concepts, that students are able to understand that legal analysis is ultimately not a doctrinal but a philosophical process.

Now imagine the same game, played with ten red cards and ten blue cards. In this case, the inherent difference between the color of the cards is apparent not only to the players, but to the observer. Given this readily identifiable distinction, there is no doubt about the predictablility of results, nor the consistency of the rule applied.

Imagine, now, a third possibility, with cards ranging from red to blue, throughout the spectrum. In this example, the extremes are apparent: there is an inherent and readily distinguishable difference between the red and blue cards. But what of the purple hues? How should the rules be applied to differentiate consistently between those which are closer to red, and therefore will be treated as red, and those which are categorized as blue? The players could apply the arbitrary standard, as used in the first game, or they could compare each purple card to a red and a blue, and determine on an ad hoc basis which color it most resembles. This test will lead to results which are far less predictable and consistent. But if the players develop a uniform standard that reflects both the inherent distinctions between red and blue, and that accounts consistently for the close cases, then predictability will be achieved.

This analogy to the process of legal analysis is peculiarly applicable in the study of personal property rights and the transactions associated with their transfer. There is something elusive about the elements which definitively identify a transaction as a "sale," a "lease," or a "security interest." We may discern some very specific characteristics about each of these concepts at the extremes, and yet lack the ability to identify the critical factors which distinguish them as they begin to approach one another. Only by focusing upon these essential aspects can we begin to understand the true nature of the transaction.[2]

We must grasp at the outset that sales, leases, and security interests are distinct transactions and are not different terms for the same rights. Each transaction has its own true nature. When we pinpoint the critical distinctions between these transactions, we will no longer be confused by the particular contract provisions used in accomplishing the transaction. The terms of the contract governing the transaction may change, and yet our understanding of its true nature should remain constant. And when this true nature has been pinpointed, we can apply the understanding to different transactions with consistent results. In those cases in which the true nature is not readily distinguishable, as with the purple cards, predictability should be the ultimate goal. However, the inherent distinctions should be pinpointed and utilized before applying a test which relies solely upon consistency.

In one sense, this categorization process is also a matter of legal realism. There is a longstanding controversy that exists in the literature of commercial law concerning the meaningful distinctions that may be made between a sale and a lease.[3]

---

2. I have used the phrase *true nature* to refer to those essential qualities of each transaction which would distinguish it, both from an economic and legal perspective, from each other transaction. It also distinguishes the true nature from those other qualities that have attracted the attention of courts addressing this problem. The phrase will be used throughout this Article to distinguish between the factors that are critical to the economic allocation effected by the transaction, and those that are not relevant to the economic analysis, and may tend to mislead participants in their discussion of these transactions.

3. *See, e.g.*, Ayer, *Further Thoughts on Lease and Sale*, 1983 ARIZ. ST. L.J. 341 [hereinafter Ayer, *Further Thoughts*]; Ayer, *On the Vacuity of the Sale/Lease Distinction*, 68 IOWA L. REV. 667 (1983) [hereinafter Ayer, *On the*

As a matter of legal scholarship, the analytical basis for distinguishing may be minimal, to some even nonexistent.[4] This Article does not take sides in this controversy, and, indeed builds upon the work of the participants. But the most compelling premise behind this Article is that the parties to these transactions understand them to be distinct, and these parties have both a legal and practical basis for so assuming.

The law has long differentiated between a sale and a lease, although it has never provided a consistent framework for the distinction in the area of personal property.[5] Further, the tax laws treat these transactions differently,[6] the rules of accounting recognize a distinction,[7] the Uniform Commercial Code (U.C.C. or Code) recognizes

---

Vacuity]; Boss, *Panacea or Nightmare? Leases in Article 2*, 64 B.U.L. Rev. 39 (1984); Boss, *Leases & Sales: Ne'er or Where Shall The Twain Meet?* 1983 Ariz. St. L.J. 357; Coogan, *Is There a Difference Between A Long-Term Lease and an Installment Sale?*, 56 N.Y.U. L. Rev. 1036, *revised and reprinted in* 1 Bender's Uniform Commercial Code Service, Secured Transactions Ch. 4.2 (1983) [hereinafter Coogan, *Is There a Difference?*]; Coogan, *Leases of Equipment and Some Other Unconventional Security Devices: An Analysis of UCC Section 1-201(37) and Article 9*, 1973 Duke L.J. 909, *reprinted in* 1 Bender's Uniform Commercial Code Service, Secured Transactions Ch. 4A (1981) [hereinafter Coogan, *Some Unconventional Security Devices*]; Coogan & Boss, *Uniform Commercial Code Treatment for All Leases*, 1 Bender's Commercial Code Service, Secured Transactions Ch. 4.3 (1983) [hereinafter Coogan & Boss, *U.C.C. Treatment for All Leases*]; Mooney, *Personal Property Leasing: A Challenge*, 36 Bus. Law. 1605 (1981); Kripke, Book Review, 37 Bus. Law. 723 (1982). The fervor of the participants in this discussion is such that it is tempting to refer to it as the "liturgy" of personal property. Working from the very valuable premises identified in these articles, I have chosen an approach suggested by legal realism. I believe that what truly matters is an understanding of the true nature of the transactions, with the ultimate goal of creating a consistent set of guidelines upon which participants in these transactions can rely in negotiation and planning. As the discussion of economic analysis *infra* at text accompanying notes 42–52 suggests, I am convinced that meaningful distinctions may be made, and my commendation of the approach taken by proposed U.C.C. Article 2A, American Law Institute and National Conference of Commissioners on Uniform State Laws, *Article 2A, Leases (with Conforming Amendments to Articles 1 and 9)* (1987 Official Text with Comments) [hereinafter *Article 2A*], and the proposed amendment to U.C.C. § 1-201(37), American Law Institute and National Conference of Commissioners on Uniform State Laws, *Article 2A, Leases (with Conforming Amendments to Articles 1 and 9)* (1987 Official Text with Comments) [hereinafter *Proposed Amendment*, U.C.C. § 1-201(37)] is that these distinctions are based upon the economic effect of a transaction—presumably the same issue upon which the parties themselves have focused. *See Proposed Amendment*, U.C.C. § 1-201(37), Official Comment (All of the tests under the Proposed Amendment focus upon economics, not upon the intent of the parties.).

4. *See* Ayer, *Further Thoughts*, *supra* note 3; Ayer, *On the Vacuity*, *supra* note 3.

5. For an excellent historical overview, see Coogan, *Some Unconventional Security Devices*, *supra* note 3, at §§ 4A.01[5][a] and 4A.02.

6. *See* I.R.C. § 168(f)(8) *as amended* by the Tax Reform Act of 1986, Pub. L. No. 99–514, § 201, 100 Stat. 2085. On the tax implications of leasing transactions, see Research Institute of America, *The Complete Analysis of the '86 Tax Reform Act* ¶ 541–42 (RIA, Inc., 1986) (a general overview of the changes in the 1986 Act); Auster, *Should the Lessor or the Lessee Claim the Investment Credit After 1983?*, 14 Tax Advisor 552 (1983) (discussing the effect of the Tax Equity and Fiscal Responsibility Act of 1982 on leasing transactions) ; Levine & Cohn, *Equipment Leasing after the Deficit Reduction Act of 1984: An Overview*, 15 Tax Advisor 531 (1984) (discussing the changes effected by the 1984 Act); Note, *From I.T.C. to U.C.C.: Using Federal Tax Criteria to Ensure Lease Treatment Under the Uniform Commercial Code*, 1986 Colum. Bus. L.J. 233 (while I disagree with the author's conclusions, the article contains a useful discussion of the effect of the Tax Reform Act of 1986 on leasing transactions).

The tax aspects of leasing transactions have probably contributed more than any other factor to the confusion between leases and secured transactions. Parties who might otherwise have created a security interest have been induced to call their transactions "leases" in order to gain available advantages. But these transactions *were* leases for tax purposes, and in some sense the economic decisions of the parties to "lease" instead of "buy" made them leases as a matter of legal realism, if not as a matter of commercial law. There has been some reason to expect that these hybrid transactions would disappear with the new tax laws, but the new laws contain provisions which favor leasing as a transaction form. *See* the Tax Reform Act of 1986, *supra*, at §201. As other economic advantages appear, new hybrids will arise, and they will still be leases to the participants, whether or not commercial law scholars and courts continue to hold their stubborn opinions that they cannot be.

7. For an analysis on the impact of accounting principles on this problem, see Coogan, *Some Unconventional Security Devices*, *supra* note 3, at §§ 4A.06[11] and 4A.06.1–.06.3.

(at least in its terms if not its application) that there is a difference,[8] and perhaps most importantly, the Bankruptcy Code distinguishes between them.[9] Like the example of the card game, if we rely first upon inherent distinctions, and aim for a goal of consistent results in the close cases, the participants, who have based their decisions upon the fact that a difference exists, will be satisfied with the rules of law that apply to their transactions.[10] It seems, therefore, that the job of lawyers is not to continue questioning whether any distinction exists, but rather to provide a framework for consistent distinctions between sales, leases, and security interests.

For example, suppose a person wishes to obtain the use of an automobile for business purposes. She goes to a car dealer, who explains that she may buy a car for cash, she may finance the purchase, or she may lease the car. Depending upon the terms of the transaction, the economic result will be different. Upon consultation with her accountant and attorney, she will decide in what form she wishes to acquire the use of the car. Her economic position will be different depending upon which transaction she chooses. To her, these are distinct transactions.[11]

What is it about these transactions which makes them distinct to the parties? It is not the label placed on them, nor the policies underlying the applicable laws that primarily concern the parties. Rather, it is the economic allocation effected by the transaction which is of primary concern. Both transferor and transferee are asking the same question: "Given the resources I have to accomplish this transfer, how can I obtain the greatest economic value?" Obviously, the relevant tax and bankruptcy laws will concern both transferor and transferee, but only because those laws may alter the economic allocation between the parties. Whether the name given to the

---

8. *See* U.C.C. § 1-201(37) (1978) (unless otherwise indicated, all citations to the Code are to the 1978 Official Text, contained in SELECTED COMMERCIAL STATUTES (West 1987)).

9. If a bankruptcy court determines that a transaction is an unexpired lease, it may be assumed or rejected by the trustee (11 U.S.C. § 365 (1982)), but in either case, the lessor retains rights to the goods. *See In re* Air Vt., Inc., 44 Bankr. 440 (Bankr. D. Vt. 1984); *In re* Atlanta Times, Inc., 3 U.C.C. Rep. Serv. (Callaghan) 893 (N.D. Ga. 1966) (decided by referee), *rev. denied* 259 F. Supp. 820 (N.D. Ga. 1966), *aff'd sub nom.* Sanders v. National Acceptance Co. of Am., 383 F.2d 606 (5th Cir. 1967). If, however, the court determines that a transaction is a sale, the seller may exercise rights in the specific goods only to the extent of his perfected security interest. 11 U.S.C. § 506(a) (1982). If the lessor has failed to make a protective filing under U.C.C. § 9-408, the interest will be unperfected, and the lessor will be an unsecured creditor in the bankruptcy, with no specific rights in the leased goods. *See* 11 U.S.C. § 544(a)(1) (1982); *In re* Pacific Express, Inc., 780 F.2d 1482 (9th Cir. 1986); *In re* Virginia Air Conditioning Co., 11 U.C.C. Rep. Serv. (Callaghan) 1260 (W.D. Va. 1972) (decided by referee). *See generally infra* text accompanying notes 142–46.

10. This is not to suggest that the participants in these transactions are satisfied with the distinctions currently provided by the law. Rather, the participants raise justified complaints both that the existing legal distinctions are incomprehensible, and that these distinctions are inconsistent. It is impossible under the current version of the U.C.C. to determine what factors will cause a court to find that a particular transfer is a security interest, and not a lease. *See infra* text accompanying notes 78–148. Further, these factors are not the same as those applied in determining whether the transfer is a sale for tax purposes, see *supra* note 6, or whether it is an executory contract under the Bankruptcy Code. *See supra* note 9. *See generally* Fogel, *Executory Contracts and Unexpired Leases in the Bankruptcy Code*, 64 MINN. L. REV. 341 (1980). But assuming that it is possible to provide a reasonable legal basis for these determinations, and a measure of consistency among the relevant laws, I do not think that people involved in these transactions think that all distinctions among them should be abolished in favor of a uniform treatment for all forms of shared interests in personal property.

11. Again, this Article does not address the merits of a policy to favor one transaction over another in the *tax* laws. Rather, no matter how we define the benefits associated with the transaction as a matter of tax policy, economic benefits can be obtained by varying allocation of property rights among the participants to these transactions. For example, the participant experiences a different economic impact if she buys the car and sells it after a week than if she leases the car for a week.

transaction is lease, sale, or security interest, the inquiry is the same. As a result, any inquiry about the true nature of these transactions must necessarily center on the manner in which the economic value represented by the goods is being allocated among the parties. All other indicia which may make a transaction look more like a sale, or more like a lease, are of only peripheral importance.

This Article argues that the courts must focus on the economic transfer effected by the transaction in order to ascertain the true nature of a personal property transfer. Part II of this Article addresses the problems that currently exist in the law governing personal property transactions. First, Part II provides a brief introduction to Article 2A, the new article of the U.C.C. which governs personal property leasing transactions. In particular, the Article focuses upon the proposed amendment to Section 1-210(37) of the U.C.C., which defines "security interest." This proposed amendment provides a uniform set of guidelines to assist courts in determining whether a particular transaction is a sale, a lease, or a security interest. Second, Part II explores in-depth the difficulty in distinguishing among these transactions, beginning with a simple model and building to a discussion of three troublesome lease provisions: the option to buy, the lease to the end of useful life, and the option to renew.

Part III analyzes the current state of the law in detail, focusing upon the extreme difficulty courts have had creating consistent standards for the distinctions among sales, leases, and security interests. It explains why the often subtle difference between a lease and a security interest is crucial in practice. Part III goes on to focus upon the proposed amendment to the definition of "security interest," which provides a uniform framework for distinguishing between leases and security interests by focusing upon economic reality, or the "true nature" of the transaction. In analyzing the proposed definition, Part III reexamines each of the complex lease provisions discussed above: the option to buy, the lease to the end of economic life, and the option to renew, supplying the Article 2A answer to the lease—security interest dichotomy in each case.

Finally, the Article focuses upon some interpretive problems still remaining under the proposed definition. The Article concludes that, while Article 2A has not entirely resolved the controversy for every case, it does provide courts with guidelines for deciding most lease–security interest issues, and it also provides a framework to guide the courts when there is no clearcut answer based upon the true nature of the transaction.

II. The Agenda for Reform: Issues to Be Resolved by Article 2A and the Proposed Definition of "Security Interest"

This Article begins its analysis by assuming that if there is a problem in understanding what is a sale, a lease, or a security interest, it is not because these are all really the same transaction, but because the basis in the law for distinguishing among them has become hopelessly blurred. The problem arises because the cases have failed to identify the factors that are critical in distinguishing these transactions in economic terms, and have focused instead on peripheral issues. Although the

blame for this confusion may be placed on the concepts themselves, it seems that the responsibility is more logically placed on the minimal guidance provided by the current version of the U.C.C.[12]

The U.C.C. simply does not explain what constitutes a sale, a lease, or a security interest. It is impossible to discern, by even the most careful reading of the Code, what the critical distinctions are between a sale and a lease. The guidance offered for distinguishing between a lease and a secured transaction raises more questions than it answers.[13]

Consequently, the parties who enter into these transactions must either choose safe positions at the extreme, or risk the possibility that a court will resolve disputes concerning the transaction by applying standards which cannot be ascertained in advance. Obviously, this uncertainty has an economic impact on the parties if it prevents them from entering into preferred transactions, or if it raises the transaction costs of the preferred transactions. The current version of the U.C.C. offers guidance to the parties only when they play their red and blue cards; when they play their purple cards, they risk a court interepretation of the transaction that ignores the parties' understanding or intent.

The issue of intent in this context is a complex one. Obviously, the expressed intent of the parties cannot be the only distinguishing factor.[14] The cases hold, quite correctly, that the interpretation of the transaction cannot be based only upon the expressed intent of the parties, since they may call their transaction one thing in an attempt to avoid the consequences of calling it what it really is.[15] There is a

---

12. A related problem is that these transactions are subject to a variety of inconsistent statutes. The tax laws offer one standard, the bankruptcy laws another, and the current version of the U.C.C. offers yet a third. *See supra* notes 6–9. Although all of these statutes implement very different policies, the policy underlying the applicable law is only relevant to the parties to these transactions insofar as it alters the economic allocation that they wish to accomplish. No one, for example, enters into a lease in order to further a policy underlying the tax laws. Rather, they wish to take advantage of relevant tax laws to effectuate a superior economic exchange, and to avoid the negative impact of an exchange which runs afoul of these laws. Surely no lessor and lessee have ever included in their negotiation over lease terms a discussion of a tax policy which may encourage or discourage one form of lease. They simply identify the necessary indicia to obtain the tax allocation they desire and incorporate them into the transaction. The difficulty arises when the tax laws require them to do something which runs afoul of the U.C.C., or which alters the agreed allocation if a bankruptcy petition is filed. *See supra* notes 6 and 9.

13. U.C.C. § 1-201(37).

14. U.C.C. § 1-201(37) uses the word "intent" when it draws the distinction between a lease and security interest, stating: "Whether a lease is intended as security is to be determined by the facts of each case . . . ." Section 9-102(1)(a) explains that Article 9 applies "to any transaction (regardless of its form) which is intended to create a security interest . . . ." Official Comment 1 to that section elaborates: "When it is found that a security interest as defined in § 1-201(37) was intended, this Article applies regardless of the form of the transaction or the name by which the parties may have christened it." It is clear from this language that neither the subjective intent of the parties, nor their objective manifestation through the language used to describe the transaction, is controlling.

> No one would contend that third parties were bound by the clear intention of the contracting parties to use a device they call a lease if the effect created by the transaction is that of a sale. The test certainly must be applied in accordance with the outward appearance of the facts rather than in accordance with the intent held by one or both of the parties while creating effects contrary to those normally produced by the kind of instrument purportedly employed by the parties.

Coogan, *Some Unconventional Security Devices*, *supra* note 3, at § 4A.01[2] n.12. *See also* G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 11.2, at 338 (1965), where Professor Gilmore explains: "It is clear enough that 'intended' in [§ 1-201(37)] has nothing to do with the subjective intention of the parties, or either of them."

15. *See, e.g.*, Leasing Serv. Corp. v. American Nat'l Bank & Trust Co., 19 U.C.C. Rep. Serv. (Callaghan) 252 (D.N.J. 1976); Brown v. Baker, 688 P.2d 943 (Alaska 1984); Lease Fin., Inc. v. Burger, 40 Colo. App. 107, 575

difference, however, between ignoring the labels that the parties attach to the transaction and ignoring their intent entirely.[16] The courts should not be misled by what the parties call the transaction, but they also should not feel free to disregard the economic transfer made by the parties in their contract.

As a result, it is critical for parties whose mutual subjective intent is to enter into a true lease to make this clear in their documents, not merely by calling the transaction a lease,[17] but also by structuring their exchange to include sufficient indicia of a true lease. The problem with this requirement, as amply illustrated by the cases discussed throughout this Article, is that it is virtually impossible to predict what set of factors will be sufficient to convince a court that a true lease exists. By misreading, rewriting, and falling into the holes in the current definition of security interest, the courts have hopelessly confused the applicable standard. The current "test" is in fact only the enumeration of an arbitrary set of factors, ostensibly based upon indicia of ownership, identified by the courts on an ad hoc basis.[18]

If the U.C.C. provided definitions of sale, lease, and security interest which focused upon the true nature of these transactions, the problems could be resolved, and a meaningful standard could be identified and consistently applied. But what test should the U.C.C. provide? Expressed intent may not be the answer, but neither is a standard that is entirely unpredictable because it focuses upon contract provisions which can be used with equal logic in sale, lease, or security interest. Any test that ignores the economic differences among the transactions misses their true nature. The only appropriate test is one that focuses upon the allocation of value, represented by the goods, which is transferred. It is this economic transfer, effected by the transaction, which appropriately distinguishes a lease from a sale or a security interest.

To resolve the confusion created by the current version of the U.C.C., the drafters of the U.C.C. have proposed a significant change in its scope. On August 1, 1986, the National Conference of Commissioners on Uniform State Laws approved Article 2A of the U.C.C., which governs personal property leasing transactions.[19]

P.2d 857 (1977); Tishman Equip. Leasing, Inc. v. Levin, 152 Conn. 23, 202 A.2d 504 (1964); State Bank of Burleigh County Trust Co. v. All-American Sub, Inc., 289 N.W.2d 772 (N.D. 1980).

16. Two separate issues are raised when a court decides the nature of a transaction without regard to the "intent" of the parties. First, no court will feel bound by objective manifestations of intent in the form of the name given to the transaction, nor by recitals of intent, nor by testimony on subjective understanding. The evidence of intent considered by the courts is apparently limited to the terms of the agreement itself (presumably including oral agreements concerning options and the like, which would tend to make a transaction a security interest). But something more is also at issue. Courts which get distracted by factors such as who pays the taxes, and who owned the equipment to begin with, are ignoring the intent of the parties at a much deeper level, since this inquiry totally misses the intended economic allocation, which is the most fundamental basis of the exchange.

17. This is insufficient under both the 1978 version of U.C.C. § 1-201(37) and under U.C.C. § 9-102(1)(a). *See supra* notes 14–15.

18. *See infra* text accompanying notes 78–148.

19. National Conference of Commissioners on Uniform State Laws, Boston, Mass. (Aug. 1, 1986). The history of the adoption of U.C.C. Article 2A is, to say the least, a complex one. In 1982, Ronald DeKoven, the Reporter for Article 2A, was retained to draft a uniform act governing personal property leasing. That project was initially entitled, The Uniform Personal Property Leasing Act (UPPLA). It went through a series of drafts during 1983–1985, and in August 1985, the National Conference of Commissioners on Uniform State Laws voted, at its meeting in Minneapolis, Minnesota, to approve the UPPLA. It was then decided that the subject matter was more appropriately included as a part of the Uniform Commercial Code. Since the Uniform Commercial Code is a joint project of the Conference and the American Law Institute (ALI), and because its governance is subject to the Permanent Editorial Board of the Uniform

The Article received the final approval of the Permanent Editorial Board of the Uniform Commercial Code in March, 1987.[20] It was then submitted to the American Law Institute, which approved the new Article on May 22, 1987.[21]

As a part of proposed Article 2A of the U.C.C.,[22] the drafters have also proposed an amendment to Section 1-201(37) of the U.C.C., which defines "security interest."[23] This amended definition provides a test for distinguishing between leases and secured transactions which places the emphasis where it belongs—on the relative economic positions of the parties as a result of the allocations made in the transaction. Its beauty is that it focuses the attention of the courts on the same issue that draws the attention of the participants: what economic value represented by the goods is being transferred from the seller to the buyer, or from the lessor to the lessee, or from the debtor to the secured party? As a result, its application reaches results based upon the same distinctions that have been considered by the participants in choosing among the available options.

Until Article 2A, there has been no comprehensive law of personal property leasing. The Consumer Leasing provisions of the Consumer Credit Protection Act[24] represent only a small portion of the law on the issue. There are various state statutes governing personal property leasing,[25] but there has been no uniform set of guidelines to assist the courts in understanding the true nature of a sale, a lease, and a security interest.

In the absence of such comprehensive legislation, lingering and troublesome questions have developed over the applicability of Articles 2 and 9 of the U.C.C. to personal property leases. For many years, courts have wrestled with the application of Articles 2 and 9 to leasing, focusing primarily on financed sales that take the form of long-term leases.

Nothing in the present Code directly addresses the rights and obligations of a lessor and lessee, analogous to the coverage for sales given in Article 2. Many courts have been unable to reach the obvious conclusion that, however unfair the result may be, the express protections of Article 2 do not directly apply to leases. Because

---

Commercial Code, it was necessary to present the Proposed Article to all three bodies for approval. *See generally Article 2A*, *supra* note 3, § 2A-101, Official Comment, History.

20. Meeting of the Permanent Editorial Board of the Uniform Commercial Code, Philadelphia, Pennsylvania, March 1987.

21. American Law Institute, Annual Meeting, Washington, D.C., May 22, 1987. The draft before the ALI was denominated, *Article 2A. Leases (with Conforming Amendments to Articles 1 and 9), Proposed Final Draft* (April 6, 1987). The Final Draft approved by the Institute was final in name only. Certain minor changes in the text were approved by the National Conference of Commissioners on Uniform State Laws (NCCUSL) at their annual meeting in August 1987. The Council of the American Law Institute and the Permanent Editorial Board of the Uniform Commercial Code appointed a committee to work with the Reporter to make minor changes in the text and comments, as they deemed appropriate, to reflect the discussion of Article 2A before the ALI, and the changes adopted by NCCUSL. It is this final version, and not the "Final Draft" presented to the ALI, which is the Official Text of Article 2A.

22. American Law Institute, U.C.C. Article 2A, Leases. Proposed Final Draft (April 6, 1987). This project was formerly identified as the Uniform Personal Property Leasing Act. *See supra* note 19.

23. *Proposed Amendment*, U.C.C. § 1-201(37), *supra* note 3.

24. 15 U.S.C. § 1667a–1667e (1982).

25. *See, e.g.*, CAL. CIV. CODE § 3308 (West Supp. 1986) (lessor's damages for lessee's breach of personal property lease); MD. FIN. INST. CODE ANN. §§ 3-206(b)(8), 3-605 (1980 & 1986 Supp.) (regulation of personal property leasing by state chartered banks).

Article 2A parallels most of the provisions of Article 2, the adoption of Article 2A should lay to rest much of the controversy concerning the applicability of Article 2 to leases.

Article 9 provides only a frail framework for distinguishing between a lease and a secured transaction, stating that it governs any transaction "intended to create a security interest."[26] While the current definition of "security interest"[27] recognizes the use of financing leases as a mechanism for creating a security interest, this definition has raised more questions than it answers. The Proposed Amendment to Section 1-201(37)[28] does away with the "intent" standard in the definition of a security interest, focusing instead upon the facts of each case.[29] But the Proposed Amendment goes on to provide specific guidelines to be applied to the transaction, that reflect the inherent economic distinctions between leases and secured transactions. As a result of this change, the parties to lease transactions will be able to anticipate and satisfy the test that will be applied to their agreement, no longer subject to an indeterminate common law standard of "intent."

Article 2A is an important development in commercial law. But the value of this change in the law of personal property leasing cannot be fully understood without a review of the analytical morass created by the courts in interpreting the application of Article 9 to leases.

A. *A Simple Model of a Sale, a Lease, and a Secured Transaction*

To understand the impact of the framework provided by proposed Article 2A, it is necessary to make some basic assumptions about the true nature of a sale and a lease as distinct transactions in their simplest forms.

First, in an unconditional sale, the buyer gets to keep the goods. The seller exchanges his or her right to the value represented by the goods for the value of the right to obtain payment. The buyer makes the reverse exchange. If the buyer fails to make good on this payment obligation, the seller may pursue the buyer, but may not pursue any specific right to the goods. By unconditional sale, the seller gives up all previous rights in the goods.

Second, in a lease, the lessor gets the goods back. The lessor exchanges the value represented by the right to *use* of the goods for the value represented by payment. The lessee agrees to make payment for the *use* of the goods.[30] Whether the

---

26. U.C.C. § 9-102(1)(a). *See also* U.C.C. § 1-201(37), which provides: "Whether a lease is intended as security is to be determined by the facts of each case . . . ."

27. U.C.C. § 1-201(37).

28. Discussed *supra* in text accompanying notes 14–18, and *infra* text accompanying notes 78–148.

29. See *Proposed Amendment*, U.C.C. § 1-201(37), *supra* note 3, Official Comment, which states:

> Reference to the intent of the parties to create a lease or security interest has led to unfortunate results. In discovering intent, courts have relied upon factors that were thought to be more consistent with sales or loans than leases. Most of these criteria, however, are as applicable to true leases as to security interests. . . . Accordingly, amended Section 1-201(37) deletes all reference to the parties' intent.

Id.

30. Although it seems clear that rent is a payment only for possession and the right to use the goods during the lease term, this concept is frequently confused. For an excellent analysis of this issue, see Coogan, *Some Unconventional Security Devices*, *supra* note 3, at § 4A.06[1] where the author states:

> The great majority of leases of personal property serve the traditional purposes of chattel lease: they supply, for

lessee makes the lease payments or not, eventually the goods are returned to the lessor. By lease, the lessor does not give up this residual value[31] of the goods, but only the right to their use during the period of the lease.

As an attempt to distinguish between a sale and a lease transaction, these distinctions may at first blush appear too simple to provide any guidance. We are, after all, still dealing with the clearcut examples of the red and blue cards. But these distinctions focus attention where it belongs—on the true allocation of economic value effected by the transaction. As the transactions become more complex, these indicia will help to point out the inherent differences among transactions as they begin to approach one another.

Finally, in a secured transaction, the debtor exchanges the value represented by *unconditional* ownership of the goods for the value represented by the secured party's

---

> a price called rent, temporary use of property. The price paid, in the form of rent, is for temporary use of an item which itself must be returned to the lessor at the end of the term . . . . The use by the lessee of the equipment for a term less than its useful life and the obligation to return it to the lessor while it still has value are the distinguishing characteristics of a lease, just as an obligation to pay the full purchase price and so acquire substantially all the benefits and risks of being the owner are the distinguishing characteristics of a sale.

Id. See also Proposed Amendment, U.C.C. § 1-201(37), *supra* note 3, Official Comment ("If a transaction creates a lease and not a security interest, the lessee's interest in the goods is limited to its leasehold estate; the residual interest in the goods belongs to the lessor."); *In re* Gehrke Enter., 1 Bankr. 647 (Bankr. W.D. Wis. 1979). (In a true lease, the lessor seeks to dispose of the use of the property while retaining the incidents of ownership; in a security lease, the lessor seeks to dispose of most or all of the incidents of ownership while retaining only a sufficient interest in the property to assure repayment of the obligation.).

31. The term "residual value" is used throughout this Article to refer to the value represented by the goods after the transaction has been completed. It is essential to understand that the term is not used in its usual sense. It is not meant to be synonymous with the reversionary interest which returns to a lessor upon completion of the lease term, although this Article's definition of residual value would encompass this reversionary interest. *See* Boss, *Lease Chattel Paper: Unitary Treatment of a "Special" Kind of Commercial Specialty*, 1983 DUKE L.J. 69 (discussing the reversionary interest in lease transactions). Nor is this term being used as it is used in Article 2A. *Article 2A*, *supra* note 3, 2A-103(1)(q) defines the "lessor's residual interest" as the interest of the lessor in the goods after expiration, termination, or cancellation of the lease contract. *See also Proposed Amendment*, U.C.C. § 1-201(37), *supra* note 3, Official Comment ("If a transaction creates a lease and not a security interest, the lessee's interest in the goods is limited to its leasehold estate; the residual interest in the goods belongs to the lessor.").

Rather, for the purpose of the economic analysis undertaken in this Article, the term "residual value" is used to include all value remaining in the goods after the transaction is complete, whether that value belongs ultimately to the lessor or to the lessee. For example, the residual value of a coat after a cash purchase is the value of a new coat. The residual value of a car after a thirty-six month lease is the value of a thirty-six month old car. According to this analysis, if we can determine who has the right to the residual value at the end of the transaction, we can determine whether the transaction is a sale, a lease, or a security interest.

The term "residual value" does not include any loss of value arising from the transaction itself. In a simple sale, virtually all value is residual: the value of the goods does not normally decrease by passage from the seller to the buyer. Of course, this is not always the case; the market value of a new car in the hands of the dealer is traditionally higher than its value in the hands of its first owner, even immediately after the sale. In a secured transaction, the residual value is the value represented by the goods after all payment has been made, either according to the security agreement, or the surplus which is available after default, repossession, and sale. The point is that one cannot accurately identify a transaction until one knows who owns the value that remains when the terms of the transaction are complete. It is this value remaining at the close of the transaction (whether by expiration, termination, or cancellation) to which the term "residual value" refers.

This concept of residual value is most easily understood when applied to the value of goods after the lease contract has been completed. During the period of use, leased goods may increase or decrease in value, or the value may remain the same. The value of use belongs to the lessee during the period of the lease, but, in a true lease, the residual value always belongs to the lessor. *See Proposed Amendment*, U.C.C. § 1-201(37), *supra* note 3, Official Comment. It is this more limited sense in which the term is used in Article 2A. *See Article 2A*, *supra* note 3, § 2A-103(1)(q). On the issue whether this residual value should be judged as anticipated by the parties at the time they enter into the transaction, see *infra* note 58 and text accompanying notes 63–66. On the issue of rising and falling market value during the lease term, see *infra* note 98.

extention of credit. That is, the debtor gives up ownership of all of the value represented by the goods, and grants an interest in the goods to the secured party. The secured party gives up the value of the credit extended in exchange for the value of the debtor's obligation, coupled with the value of an interest in the goods. The debtor is entitled to uninterrupted use and enjoyment of the goods as long as the payments are made.

The right transferred to the secured party is conditional in nature. While the secured party holds a property interest in the goods, the right to realize on this interest is contingent upon the debtor's default under the security agreement; only when a default occurs can the secured party interfere with the debtor's use and enjoyment of the goods. In effect, the property interest provides assurance that the debtor will honor the payment obligation. The secured party is entitled to payment or to the value represented by the goods, but not both.[32] Further, the secured party is not entitled to possession of the goods unless and until there has been a failure to pay—that is, a default—by the debtor.[33]

The secured transaction, in its most basic form, is therefore distinguishable from both an unconditional sale and a lease. In a simple sale, all value represented by the property vests in the buyer. Neither a seller nor an unsecured financer has any rights specific to those goods.[34] In a lease, two parties share the value represented by the goods—the lessee obtains the right to use, and the lessor retains the residual value after the period of use is over. In a secured transaction, the debtor holds the value of the goods, subject only to the contingent right of the secured party to claim it in the event of nonpayment.

Next, one must decide whether these three transactions are mutually exclusive. Identifying the true nature of each transaction is manifestly more difficult when elements of more than one category of transfer are present in the same transaction. The following is a basic description of possible transactions:

---

32. That is, the secured party is entitled to only one satisfaction of the debt. The secured party may obtain it through payments, or through realization on the collateral, or even realization plus deficiency, but cannot realize on the collateral without applying the value obtained through this process to the debt. *See* U.C.C. § 9-504(1)(b).

33. The simplification in the text is intentional in order to focus upon the true nature of a secured transaction. It is true that the law may permit recovery of the goods for reasons other than failure to pay. The security agreement may provide that acts by the debtor, other than nonpayment, constitute default giving rise to a right to possession. But these acts are directly related to the prospect of payment, and as such, subsumed in the secured party's right to payment. For example, failure to maintain or insure the collateral may constitute a breach under the security agreement. Although not immediately apparent, this obligation is closely related to the debtor's obligation to pay, because it represents his obligation to protect the collateral for the secured party's future protection against nonpayment. The secured party is not primarily interested in the collateral, nor in its maintenance, but rather in his right to obtain payment. His contingent right to realize on the collateral is only of interest to him if he does not receive payment. Absent a right to recover the goods in the event of default, no value is passed to the secured creditor by the debtor's obligation to insure or maintain the collateral. Indeed, there is an argument that the primary value of a security interest is not its insurance value, which provides payment in the event that the debtor fails to pay, but its leverage value, permitting the secured creditor to insure payment by threatening the debtor with the loss of the use of the collateral. Regardless of the analysis used, the result is the same: the secured party's prospect of being paid is enhanced by the existence of the security interest.

34. For simplicity, this Article avoids the other legal processes by which a party other than the buyer/owner may have rights to the goods, such as the right of a judgment creditor to force sale of the goods levied upon to satisfy the judgment, or the right of a seller to replevy goods. *See* U.C.C. § 2-702. The focus instead is upon the nature of transactions in which rights to the goods pass *voluntarily* from one party to another.

(1) There can be a simple sale without a security interest. This would include such transactions as a sale of goods for cash or a sale of goods for unsecured credit.

When the buyer obtains goods through a sale, whether for cash or unsecured credit, the value of that property is obtained, and the seller does not retain any value in the goods sold.[35] The seller trades her value in the goods for the proceeds, whether the proceeds take the form of cash, a check, an open account, or a note. All value in the goods passes to the buyer. This is true even when the sale is financed by someone other than the seller, as when the purchase is made with a credit card.

In this exchange, the rights of the buyer and seller are governed by Article 2 of the U.C.C. Nothing in Article 2 upsets the basic notion that this transaction is a transfer of the value of the goods from the seller to the buyer.[36]

(2) There can be a secured transaction without a sale. Rights to the goods are voluntarily transferred from the owner to the secured party. But the secured party's right to realize on the goods is contingent, intended to secure payment of money.[37]

(3) There can be a sale combined with a secured transaction. The secured party (either the seller or a third party financer) obtains a contingent interest in the goods voluntarily from the buyer, in conjunction with the passage of the goods from the seller to the buyer. The seller *qua* seller has given up all interest in the goods. The seller or financer, as secured party, obtains an interest in the goods, but only to secure performance of the buyer/debtor's payment obligation.[38]

---

35. *See supra* note 34.

36. There are exceptions in Article 2 that give the seller rights in the goods even in an unconditional sale. *See, e.g.*, U.C.C. § 2-702 (seller has the right to reclaim goods delivered on credit while the buyer was insolvent). Creation of an exception for insolvency illustrates the general rule of Article 2: the seller gives up all rights in the goods upon delivery.

37. See U.C.C. § 9-105(1)(d), which defines the debtor as the party who owes payment or other performance of the obligation that is the subject of the security interest. As discussed *supra* note 33, the debtor's obligation may literally require the debtor to do things in addition to making payment. *See, e.g.*, U.C.C.§ 9-503.

38. There are, of course, complex issues arising under the Holder in Due Course (HDC) doctrine of U.C.C. Article 3, and the rights of a debtor to raise defenses against the secured party notwithstanding HDC status under the Federal Trade Commission (FTC) Holder in Due Course Rule, 16 C.F.R. § 433.2 (1986), the Uniform Consumer Credit Code (1974) or other relevant state legislation. These aspects have been ignored here since they artificially combine rights arising from two separate transactions in an effort to protect the buyer from the otherwise existing inability to combine the rights arising in these transactions.

The question is this: Under what circumstances can the defenses, arising from the transfer/sale of property, be raised against the party to whom the debt is owed? The problems arise not from a relationship between the sale and the secured transaction, but from the necessary connection between the payment obligation and the sale on one hand, and the payment obligation and the secured transaction on the other. At the most fundamental level, the question is, "when can I raise defenses to my payment obligation against the secured party which arise exclusively from my transaction with the seller?" The solutions that have been devised recognize the distinct nature of these transactions.

This problem arises because a seller may freely transfer the right to payment while retaining concomitant obligations to the buyer. When assignment of a debt in the form of a negotiable instrument, or even a debt and security interest as represented by chattel paper, is viewed as distinct from assignment of the contract obligation as a whole, there is a fundamental recognition of the severability of the entitlement to payment from the continuing obligations of the seller. It is the *transfer of the payment obligation* which raises this problem, and not any necessary connection between the sale and the security interest. Under the U.C.C. Holder in Due Course doctrine, transfer of the payment obligation separate from the contract obligation may cut off defenses arising from the underlying transaction. This concept is also codified in U.C.C. § 9-206 (permitting waiver of defenses in a secured transaction); the FTC Holder in Due Course Rule; and the UNIF. CONSUMER CREDIT CODE §§ 3.307 and 3.404 (1974).

For example, while the law may permit a buyer to refuse payment to a secured creditor in some circumstances based upon a failure of the goods, this right is exclusively *defensive*. No court would permit a suit by the buyer as plaintiff against the secured party as defendant based upon breach of warranty by the seller. The proper defendant in such an action is the seller, and not the secured party. Thus, the law recognizes that these rights arise against separate parties based upon distinct transactions, regardless of their interaction when the obligation of payment has been transferred from seller to

These descriptions indicate that elements of a sale and a secured transaction may exist as parts of the same exchange. This is inherent in the concept of secured transactions. However, it is essential to understand that these aspects of the transaction are distinct, and that each element (sale and security interest) is separate, giving rise to rights and liabilities independent of the other.[39] For example, the buyer who purchases goods expects the seller to comply with Article 2 of the U.C.C. The seller may have obligations with respect to the quality of the goods. If the buyer obtains secured financing from a third party, that secured party undertakes no obligations under Article 2. The financer is not responsible for the quality of the goods. The sale aspect of the transaction is wholly separate from the rights and liabilities of the secured party.

On the other hand, the secured party is obligated to comply with the provisions of Article 9 of the U.C.C., while the seller has no such obligations. When these transactions are combined into one, so that the seller is also a secured party, this distinction remains: the seller *qua* seller is liable under Article 2 only, and the seller *qua* secured party is liable under Article 9 only.

(4) Another possible transaction is the lease of goods. No single transaction can be both a sale and a lease of the same goods. A sale is an unconditional exchange of the value of the goods for payment. A lease is an exchange of the right to use of goods for payment. Since the right to use the goods is presumably included in their sale, it is anomalous to suggest that the seller could obtain payment both for the unconditional transfer of the goods, and for their use after transfer. The reverse is also true. If the transaction is a lease, it is only use which is exchanged for payments, and not the unconditional right to the goods.[40]

(5) Finally, no single transaction can create both a lease and a security interest in the same goods. Since in a security transaction there is only a contingent right to

---

secured party. A case which focuses upon this distinction in a disguised lease transaction is Chemical Bank v. Rinden Professional Ass'n, 126 N.H. 688, 498 A.2d 706 (1985). In that case, a law firm obtained a telephone system through a lease-purchase agreement from a supplier. The supplier then assigned the lease to Chemical. The assignment was accompanied by a waiver of defenses agreement by Rinden. When Rinden refused to pay the assignee, the assignee filed suit. Rinden attempted to raise defenses against the assignee arising from the sale transaction, arguing that the waiver of defenses and consent to assignment provisions were unconscionable. The court found that the transaction was a disguised security agreement, subject to Article 9, and that a sale had occurred, so that Article 2 was also applicable. *Id.* at 693, 696, 498 A.2d at 711, 713. It held that the assignment complied with the provisions of both Articles 2 and 9, that the waiver of defenses against the assignee was enforceable, and that the assignee was a holder in due course, free of the defenses arising from the sale transaction. The lessee could have pursued remedies against the supplier under Article 2, but as so often happens, the supplier had filed bankruptcy. *Id.* at 697, 498 A.2d at 714. By a finding that the assignee was an HDC, the court recognized that the assignee obtained the payment obligation and the security interest, but not the underlying obligation which gave rise to Rinden's defenses in this action.

39. The suggestion is not that the same contract cannot include elements of both transactions, but rather that each transaction is distinct and exclusive. A lease with a subsequent sale of leased goods is *two transactions*: a lease, and a sale. It is not possible (for the reasons addressed in the text) for the same transfer to effect both a sale and a lease. A "sale-leaseback" transaction raises an interesting problem. In such cases, the lessee is the original owner of the goods, who transfers them to the lessor, and then leases them back. If the transaction is a true sale and lease, then there are two distinct transactions: the sale of the goods from the seller/lessee to the new owner/lessor, and the lease of those goods back from lessor to lessee. But if the transaction is a disguised security interest, then there is only one transaction: the grant of a security interest in the goods from the nominal lessee to the nominal lessor.

40. *See supra* note 30.

realize on the goods, the secured party cannot at the same time also hold the unconditional right to return of the goods which characterizes the rights of a lessor.[41]

B. *Economic Transfer in Sale, Lease, and Security Interest*

Another way to characterize the distinction between a sale, a lease, and a security interest is to identify the holder of the residual economic value[42] represented by the goods when the transaction is complete. In a simple sale, the residual value passes unconditionally to the buyer. The seller does not get the goods back; the residual value is wholly owned by the buyer when the transaction is concluded.

In a secured transaction, the buyer retains the residual value in the goods and the secured party has contingent access to it only in the event of breach, and only to the extent of the remaining debt.[43] Article 9 recognizes that this residual value remains the property of the debtor even after breach, by requiring the secured party to account to the debtor for any surplus after the debt is extinguished.[44]

In a true lease transaction, however, the residual value of the goods returns to the lessor.[45] If the payments are made, the residual value returns at the end of the lease term. If the payments are not made, the residual value returns earlier. But by definition, a true lease gives the lessee no claim to that residual value that is comparable to the rights of a debtor to the surplus under Article 9.[46] Absent a

---

41. *See* DeKoven, *Leases of Equipment:* Puritan Leasing Company v. August, *A Dangerous Decision*, 12 U.S.F. L. REV. 257 (1978). There is an argument that the right to repossess leased goods upon nonpayment of rent is identical in economic terms to a security interest, because it secures payment of the rent, and is contingent upon default. But this right should be categorized differently. Since rent entitles the lessee to retain possession and use of the leased property, a failure to pay rent terminates the lessee's right. All residual, including the right to possession and use, reverts to the lessor, *not* to secure a continuing payment obligation, but to return this residual to its rightful owner. Upon return of the goods, the lessor is only entitled to be made whole for the use which has been uncompensated, and for other damages related to the default. See *infra* note 46 which discusses damages upon default. No one would argue that, in a true lease, the lessor is obligated to sell the property to recover damages from the breach of the lease.

42. Residual value is defined as the value remaining in the goods after the transaction is completed. *See supra* note 31.

43. But see U.C.C. § 9-505(2), which permits the secured party in certain circumstances to retain the collateral in full satisfaction of the debt. Since the debtor has the right to prevent this action, even this Code provision recognizes the debtor's ultimate ownership of that residual value. Presumably if the residual value is greater than the debt, the debtor will insist upon disposition. After the debt to the secured creditor has been satisfied, the surplus must be delivered to the debtor. *See* U.C.C. § 9-504(2).

44. *See* U.C.C. § 9-504(2). *See generally* Ayer, *On the Vacuity*, *supra* note 3.

45. *See* DeKoven, *supra* note 41, at 279 ("In a true lease the lessor's mitigation is limited to the reasonable value of the use of the equipment for the term . . . .").

46. Although it is beyond the scope of this Article to discuss at length the differences between the remedies available to a lessor at common law and those available under Part 5 of Article 9, there are two relevant points that can be made. First, a true lessor is the owner of the residual economic value under the lease. The lessee has no right to demand upon default that the lessor dispose of the leased goods, and as a result, the lessor need not account to the lessee for this value on default. *See* DeKoven, *supra* note 41, at 266–68; DeKoven, *Proceedings After Default By the Lessee Under a True Lease of Equipment*, in 1C BENDER'S UNIFORM COMMERCIAL CODE SERVICE, SECURED TRANSACTIONS Ch. 29B at § 29B.03[2]. Professor Coogan explained it this way: "What might be thought of as the collateral—the equipment—belongs to the lessor, not the lessee. It makes no sense to tell the lessor to sell his own property in order to collect the lessee's obligation to him." Coogan, *Is There a Difference?*, *supra* note 3, at § 4AA.03[1]. On the other hand, since a lessee under a disguised security interest is the owner of the residual economic value, the application of Article 9 to this transaction would require the nominal lessor to apply the amount received on disposition of the property to any deficiency, or to account to the nominal lessee for any surplus. *See* U.C.C. § 9-504. *Proposed Amendment*, U.C.C. § 1-201(37), *supra* note 3, Official Comment.

subsequent purchase of the goods by the lessee, the lessor remains the holder of the residual value of leased goods.

Once again, it is apparent from the analysis of residual value that no transaction can effect both a lease and a security interest in the same goods. The lessor's right to return of the goods is conditional during the period of the lease, because it is conditioned upon default. But when the term of the lease is complete, the true lessor is unconditionally entitled to return of the residual value.[47] On the other hand, while the secured party's right to the goods during the term of the security interest is conditional upon payment, once payment is complete, the secured party's contingent right to the goods is extinguished, and all residual value in the goods belongs to the debtor.

C. *The Importance of Obligation in the Analysis*

This discussion raises an important related point. Even under the current definition of "security interest,"[48] a court is justified in finding that a security interest exists only when the transaction terms impose upon the nominal lessee an absolute obligation to pay. This so-called "hell or high water" clause is the *sine qua non* to a finding that the transaction is a disguised security interest; no security interest exists if the obligation of the lessee under the lease is terminable.[49]

For example, if the lessee has the right at any time during the transaction to return the goods, with no obligation to make future payments under the lease agreement, this cannot constitute a sale and security interest.[50] From the discussion of the economic allocation effected by a sale, it is clear that a court cannot find that the lessee is the holder of the residual value, and therefore a de facto purchaser, unless the lessee is unconditionally obligated to complete payments for the transfer of the goods. If the lessee can walk away from the transaction with no further obligation, it is not a purchase subject to a security interest, but a true lease. Although some cases have ignored this factor,[51] these holdings are inconsistent with the most basic aspect

---

47. Of course, if the lease contains an option to buy, even the true lessor does not have an unconditional right to return of the residual value. The lessor has the right either to return of the goods or to payment for their residual value, once again establishing the true lessor as the owner of the residual value. For a more thorough analysis of this problem, see *infra* text accompanying notes 53–76.

48. U.C.C. § 1-201(37).

49. Coogan made this point quite forcefully in his discussion of *In re* Royer's Bakery, 1 U.C.C. Rep. Serv. 342 (Callaghan) (Bankr. E.D. Pa. 1963) (decided by referee):

> A surprising aspect of the referee's opinion was that in holding the transaction to be a conditional sale he attached no significance to the fact that the lessee had an option to terminate at any time, a term hardly characteristic of a sale and a crucial fact that under black-letter pre-Code law would have led to an opposite result.

Coogan, *Some Unconventional Security Devices*, *supra* note 3, at § 4A.01[2][c][vi][A].

50. *See, e.g.*, *In re* Marhoefer Packing Co., 674 F.2d 1139 (7th Cir. 1982); RCA Corp. v. State Tax Comm'n, 513 S.W.2d 313 (Mo. 1974); U.S. Fidelity and Guar. Co. v. Thompson and Green Mach. Co., Inc., 568 S.W.2d 821 (Tenn. 1978); *In re* Coors of the Cumberland, Inc., 19 Bankr. 313 (Bankr. M.D. Tenn. 1982); Arnold Mach. Co. v. Balls, 624 P.2d 678 (Utah 1981).

51. *See, e.g.*, *In re* J.A. Thompson & Son, Inc., 665 F.2d 941 (9th Cir. 1981); *In re* Vaillancourt, 7 U.C.C. Rep. Serv. (Callaghan) 748 (Bankr. D. Me. 1970) (decided by referee); *In re* Royer's Bakery, Inc., 1 U.C.C. Rep. Serv. 342 (Bankr. E.D. Pa. 1963) (decided by referee). *See supra* note 49. The cases that have so held have relied upon the existence of a nominal price option, holding that the existence of such an option creates a security interest under § 1-201(37) as a

of the true nature of a sale (that the residual value is unconditionally transferred to the buyer), and also with the true nature of a security interest (that the secured party has only a contingent right to the residual). When there is no obligation to continue making payments under the "lease," the transaction must necessarily be a true lease, since the residual remains at all times with the lessor, and the lessee has undertaken no obligation to purchase this residual.[52]

We cannot, however, reverse the logic to find a true lease only in those cases when the payment obligation is terminable. Either type of payment obligation—terminable or absolute—is consistent with the existence of a true lease. For example, a true lease may contain a clause that permits the lessee, upon return of the leased goods, to avoid any further payment obligation. This is a terminable contract to lease the use value of the goods—one form of a true lease. A true lease might also include an obligation which is absolute, requiring the lessee to continue making payments even when the goods are returned. The reason for this is quite simple: the lessee in a true lease is contracting only for the possession and use of the goods during the lease term. The parties may agree that payment for this use is either a terminable or an unconditional obligation, but it does not change the economic allocation. In either case, the lessee is contracting only for use, and not for the residual. As a result, while a terminable obligation is incompatible with the true nature of a security interest, a true lease is compatible with either a terminable or an absolute payment term.

In summary, the true nature of each of these transactions makes them distinct and independent. A lease is not a sale, a sale is not a secured transaction, and a secured transaction is not a lease. While we may combine the concepts of sale and security interest in a single transaction, these are separate aspects of the relationship between the parties. However, we may not, in a single transfer, combine a lease with either a sale or a security interest, because the true nature of a lease is incompatible with the concepts inherent in either sale or security interest.

D. *Analyzing Some Problem Transactions for Their True Nature*

When these transactions appear in their simplest forms, as we have discussed them above, and when both the parties and the documents reflect the true nature of the transactions, no problems arise in applying the U.C.C. to the transaction. In these cases, we can say with confidence that red is red, and blue is blue. The answer is deceptively simple: Article 2 applies to sales, Article 9 applies to secured transactions, and neither applies directly to a true lease.

Problems developed when courts analyzing more complex transactions failed to give full effect to the distinct nature of these concepts. It is not that the parties are not entitled to choose whatever mechanism they wish to accomplish the transfer of rights. Rather, the problems exist because courts applying the U.C.C. to these "purple"

---

matter of law. See *infra* text accompanying notes 54–66 and notes 150–186 for a discussion of options and their effect on the existence of a security interest.

52. The result is the same under the Proposed Amendment, which requires that the consideration paid by the lessee not be subject to termination in order to find a security interest. *See infra* text accompanying note 156.

transactions have had extreme difficulty identifying the true nature of a sale, a lease, and a secured transaction.

Upon closer inspection, there is ample reason for confusion in the law governing personal property. The problems become readily apparent when more complex examples of these transactions are examined: the Option to Buy;[53] the Lease to the End of Useful Life; the Option to Renew. Each of these contract provisions raises different questions about the categorization of the transactions. However, the true nature of each transaction should remain the same regardless of the contract terms used to effect the allocation. A review of the variety of means by which these terms may operate should lead to consistent and determinable results.

1. *The Option to Buy*

In a simple analysis of leases the existence of a residual value at the end of the lease term is assumed. If the residual value returns to the lessor at the end of the lease term, that transaction qualifies as a true lease. What result if the "lease" contract grants to the "lessee" the option to buy this residual value? Is this contract a sale with a security interest retained by the nominal "lessor," or a true lease? There are several possible transactions.

a. *The Mandatory Option*

If the contract requires the lessee to exercise the option at the end of the lease term, the transaction is a sale. The nominal lessor in this example has not retained the right to the residual value at the end of the lease, but has transferred all value, both use and residual, to the lessee for a price consisting of the lease payments plus the option payment. The lessee has undertaken the unconditional obligation to purchase both the use and residual value of the goods. Any interest retained by the "lessor" is a security interest—that is, a contingent right to the goods to secure payment.[54]

b. *Optioning Out of the Lease Obligation*

Suppose the contract contains an option to purchase, but the option price permits the lessee to purchase the residual value of the goods (including the right to use them, of course) for less than the cost of performance for the remaining lease term. This

---

53. Oddly enough, once it is known whether these transactions are leases or sales, the answer to the question whether or not there is a security interest in the goods is easy. If the answer is that the transaction is a true lease, there can be no security interest, because no transaction can simultaneously embody both a lease (unconditional right to possession of the goods at the end of the transaction or upon default) and a security interest (conditional right to possession of the goods upon default). If the transaction is actually a sale, then there is also a security interest because the rights in the goods which have been disguised as a lease represent not (as they have been represented by the parties) an absolute right to return of the leased goods, but a contingent interest in the goods to secure payment—a security interest. *See* U.C.C. § 1-201(37) (seller's reservation of title notwithstanding delivery to the buyer is limited to a security interest, although reservation of title under a lease which is not intended as security is not a security interest); Coogan, *Some Unconventional Security Devices*, *supra* note 3, at § 4A.01[2]. Of course, if the secured party has not taken steps to perfect the security interest, the existence of this right may provide little solace. See *infra* text accompanying notes 131–48, discussing the application of Article 9 to disguised leases.

54. *See, e.g.*, *In re* Coors of Cumberland, Inc., 19 Bankr. 313 (Bankr. M.D. Tenn. 1982). The result is the same under the Proposed Amendment. *See Proposed Amendment*, U.C.C. § 1-201(37)(first b), *supra* note 3, and *infra* text accompanying notes 150–89.

would also constitute a sale.[55] If the lessee can obtain use and residual value for less than the cost of use alone, the economic realities of the transaction for both parties are the same as in the mandatory option case.[56] If the nominal lessor is contractually obligated to part with the residual value for the option price alone, and the option price is the economically favorable mechanism for the lessee to obtain the use of the goods, then a sale has occurred.[57]

c. *Option Price Too Low*

In this example, the contract contains a true option (that is, the lessee is under no compulsion to exercise the option, unlike the previous two examples), but the payment to the lessor is less than the anticipated residual value of the goods at the end of the lease term.[58] The true nature analysis suggests that this option creates a sale and disguised security interest because the anticipated residual value of the goods is greater than the amount paid for it. The insufficient amount of the option payment makes clear that the lessor has already transferred ownership of the residual value to the lessee in exchange for the lease payments. Otherwise, there is no incentive for the lessor to have agreed to part with the residual for an amount less than its anticipated value. In this circumstance, the lease payments presumably have compensated the lessor for the ownership interest in the residual, and the lessee is actually a buyer, having purchased both the use value and at least a portion of the residual value

55. Keep in mind the discussion of unconditional obligation to pay, *supra* text accompanying notes 48–52. When the obligation is terminable, the cost of completing the lease is zero, since the lessee has the legal right not to make any further payments. If the lessee has no obligation to continue making payments under the lease and can terminate the transaction, then exercise of the option would not be for an amount less than the cost of completing the lease, and the transaction does not fall within this hypothetical.

56. Again, the result is the same under the Proposed Amendment. *See Proposed Amendment*, U.C.C. § 1-201(37)(x)(ii), *supra* note 3.

57. In calculating the cost to the lessee of completing performance under the lease, one cannot compare only the dollars paid under the option with dollars paid to complete the lease. Naturally the time value of money must also be taken into account. Only if the option price plus interest thereon is less than completion of the lease has a security interest been created.

58. The phrase "anticipated residual value" focuses attention on the economic expectations of the parties at the time the lease transaction is entered into, and not the time when the option is exercised. For reasons addressed in the text *infra* at notes 63–66, it is more appropriate to make this determination when the option is granted, because it is at this point that the determination of whether a transaction is a lease or a security interest must be made. Any other timing for this evaluation permits a lease which was believed by the parties at its inception to be a true lease, to be "transubstantiated" into a security interest if the residual turns out to be more valuable than the parties anticipated at the inception of the transaction. *See infra* text accompanying notes 106–14.

Most of the cases which have addressed this issue have compared the option price with the value of the goods at the time the option is exercised. *See, e.g., In re* Reserves Dev. Corp., 36 U.C.C. Rep. Serv. (Callaghan) 1327 (Bankr. W.D. Mo. 1983); Peco, Inc. v. Hartbauer Tool & Die Co., 262 Or. 573, 500 P.2d 708 (1972); Davis Bros. v. Misco Leasing, Inc., 508 S.W. 2d 908 (Tex. Civ. App. 1974). None of these judges was confronted with proof of a residual value that was nominal at the time the lease was entered into, that became a realistic measure of actual residual value by the time of exercise, nor the reverse situation. One court has recognized that the appropriate measure for determining whether an option is nominal is the fair market value of the leased goods as anticipated by the parties when the option is granted, and not the actual fair market value at the time the option is exercised. *See In re* Marhoefer Packing Co., 674 F.2d 1139 (7th Cir. 1982). As discussed *infra* text accompanying notes 63–66, if a choice must be made between residual value as anticipated at the time of contracting or actual residual value at the time of exercise, the point of contracting gives a more reliable standard for distinguishing between leases and secured transactions.

through payments during the lease term. The option payment is nothing more than the completion of the sale of the residual value to the buyer.[59]

d. *The Right Option Price*

This contract contains a true option, and the amount of the option payment is equal to or greater than the anticipated residual value of the lease goods. This is a true lease and not a disguised security interest. Although it is a lease coupled with an option to buy, these are separate transactions. The true nature of each is reflected in the economic allocation of value under the contract. There is no sale until the option is exercised and there is no compulsion on the lessee to exercise the option. The lessor remains the owner of the residual value until the exercise. At this point the lessor is fully compensated for the residual value by the option payment: the lease payments compensate the lessor for the value of the use of the goods during the lease term, and the option payment fully compensates the lessor (who only becomes a seller when the option is exercised) for the residual value in the goods.[60]

e. *The Nominal Option Price*

What if the lease contains an option price which is nominal? Much of the discussion about option prices has centered upon the issue of whether the option price is nominal, because the 1978 version of Section 1-201(37) states that a nominal price option creates a security interest.[61] Unfortunately, there is no current Code definition of nominal. Does "nominal" mean a small dollar amount, or an amount which is small in relation to the value of the residual transferred? If the option price is less than the anticipated residual value, we know from Example 1(d) above that this is a disguised sale and security interest.

But what if the option price is a small amount because the anticipated residual value of the leased goods at the end of the lease term is a small dollar amount? This should not constitute a nominal price option. So long as the option price is equal to or greater than the residual value of the goods, the transaction remains a true lease. The fact that only a few dollars are required to fully compensate the lessor should not turn this into a nominal price option, and thereby, into a security interest.[62]

---

59. To the same effect, see *Proposed Amendment*, U.C.C. §§ 1-201(37)(first d) and (x), *supra* note 3. *See infra* text accompanying notes 192–200.

60. See *Proposed Amendment*, U.C.C. § 1-201(37)(x), *supra* note 3, which provides:

> Additional consideration is not nominal if (i) when the option to renew the lease is granted to the lessee the rent is stated to be fair market rent for the use of the goods for the term of the renewal determined at the time the option is to be performed, or (ii) when the option to become the owner of the goods is granted to the lessee the price is stated to be the fair market value of the goods determined at the time the option is to be performed. . . .

Id. See also id., Official Comment.

61. The 1978 version of U.C.C. § 1-201(37) states that "an agreement that upon compliance with the terms of the lease the lessee shall become or has the option to become the owner of the property for no additional consideration or for a nominal consideration does make the lease one intended for security." See *infra* notes 87–113 and accompanying text for a discussion of this provision. See also *infra* notes 190–217 and accompanying text for this provision's treatment under the Proposed Amendment.

62. But the reader should be aware that a lease with a residual that is worth only a small dollar amount at the end

This discussion leads to another important issue: When is the appropriate time for a determination that the option price compensates the true lessor for the lessor's residual value? The phrase "anticipated residual value" has been used because the expectations of the parties at the time the option price is set are more relevant than the actual residual value when the option is exercised. In a perfect world, these would always be the same, and one would always know a true lease by comparing the option price to the actual value of the goods at the time the option is exercised. In reality, however, goods rise and fall in value contrary to the expectations of the parties.[63] If one does not use the anticipated value at the time the lease with option is entered into, then a true lease is "transubstantiated" into a disguised security interest by a rising market, and a disguised security interest becomes a true lease in a falling market.[64]

For example, suppose that the parties anticipate that the leased goods will have a fair market value of $500 at the end of the lease term. An option in the lease agreement grants the lessee the right to purchase the goods at the end of the lease term for $500. Under a true nature analysis, this is a true lease, because the amount of the option payment fully compensates the lessor for ownership of the anticipated residual value. But suppose that the goods rise in value unexpectedly during the lease term, so that the goods which were anticipated to be worth only $500 are now worth $1500. If the character of the transaction is fixed at the time the option is granted, this change in market value cannot affect the rights of the parties to the transaction. On the other hand, a test that looks to the value of the goods at the time the option is exercised will transform this true lease into a disguised security interest.

Application of Article 9 to such a "transformed" security interest is profoundly troublesome. At the time the transaction is entered into, the parties have every reason to believe that no filing is necessary, but by the time the transformation has occurred, it is too late to file. Filing at the time when the option is exercised is

---

of the lease term may in fact be a lease to the end of useful life. *See infra* notes 67–72, 74–76, and 190–217 and accompanying text.

63. See *infra* note 98 for a discussion of rising and falling market values, and their effect on lease transactions. Professor Ayer has argued that the allocation of upside and downside risk, both indicia of ownership, make long-term leases and sales indistinguishable. *See* Ayer, *On the Vacuities*, *supra* note 3, at 671–81. I do not think that the allocation of risk should determine whether the transaction is a sale or a lease. The characterization of the transaction should remain the same under true nature analysis whether the relevant risk is viewed as being whether the *use* value will rise or fall, or the risk is whether the *residual* value will rise or fall. For example, in a true lease, the lessor gives up the use value for her realistic estimate of the current and future value of the use of the goods. Even if the use value rises dramatically, this would not change the lease from a true lease into a sale and security interest. The lessor is still the owner of the residual value, and has parted with use for the anticipated fair market value at the inception of the transaction. The same is true of option prices. The lessor who grants an option to buy makes a realistic evaluation of the worth of the residual when the option will be exercised. If the goods unexpectedly rise in value, then the lessee has made a good bargain, and will probably exercise the option, but this should not change the fact that the transaction is a true lease. The lessor asked an option price intended to fully compensate her for the anticipated residual, and the fact that the lessor retains the downside risk and the lessee obtains the upside benefit is irrelevant.

If an unanticipated change in market value were to change the transaction from a lease into a sale solely because the lessor has parted with the upside benefit by granting a fixed option price, what are we to make of the transactions, currently in vogue, wherein a seller contractually agrees to repurchase a car (or a diamond ring) for a fixed price? The seller has retained the downside risk, but surely this does not change a transaction wherein the seller has parted with *all* residual value, from a sale back into a lease!

64. See *infra* notes 150–89 and accompanying text discussing this timing in *Proposed Amendment*, U.C.C. § 1-201(37), *supra* note 3. See *supra* note 58 discussing the fact that many courts addressing this issue have looked to the value of the goods at the time the option is exercised.

pointless: if there has been no default under the agreement, upon exercise of the option, the lessor gets the option payment and has no complaint, regardless of whether the lease is a true or disguised lease transaction. But if the lessee has already defaulted, the lessee's creditors or bankruptcy trustee will already be claiming that the lessee is the owner of the leased property, so that filing at this point is too late to protect the interests of the lessor. The evaluation of residual value should be made according to the realistic expectations of anticipated residual value when the lease transaction is entered into.[65]

The true nature analysis reinforces this result. It is only anticipated value that is relevant in determining what economic exchange the parties *have already effected* by the terms of their agreement. The fact that the actual value of the residual may rise or fall while the option price remains stable is irrelevant. An unexpected rise in the residual value should not transform a true lease into a sale any more than any other option to buy creates a sale solely because the value of the item rises. There is no sale until the option is exercised. The relevant question is not, "when will the lessee choose to exercise the option, because it is a good deal?" but rather, "when, considering the anticipated value of the residual, has the lessor *already sold* the residual to the lessee?" If the option price is less than the anticipated residual, the answer is that the lessor has sold the residual at the inception of the transaction, and there never was any true lease.

The problem of recharacterizing the transaction based upon changing value of the residual does not arise when the parties enter into a lease with no option but later grant an option, or when they enter into a lease with an option but do not specify the option price.[66] In either of these circumstances, the lessee has no claim to the residual value until the price is agreed upon between the lessor and lessee. Thus, unlike the lease in which the option price is set in the original agreement, there is no possibility that the lessor has already transferred her interest in the residual value to the lessee through the lease payments. The economic realities of such transactions permit the use of the anticipated value at the time the option price is set. In either case, there is no incentive for the lessor to agree to a price which reflects anything but the actual value of the lessor's residual interest. Even if the lessor were to agree to such a transfer, the recharacterization occurs at the time this "too-low" option price is set, and it does not relate back to the beginning of the transaction.

2. *Leases to the End of Useful Life*

Recall that the analysis of the true nature of a lease presupposes a residual economic value at the end of the lease term. Can a true lease exist when the term is

---

65. *See supra* notes 54–62, and *infra* notes 87–114, 150–89, and accompanying text.

66. In the case when there is an agreement to grant an option, but no option price is specified, U.C.C. § 2-305 might be of importance in setting the price, but this would normally result in a price that compensates the lessor for full value of the residual. A lease that contains a formula for the option payment must be treated as one that specifies the option price. Since the lessor is bound to transfer the residual for the amount determined by the formula, we can determine at any point whether the formula compensates the lessor for the anticipated residual value. Most leases which use this approach are disguised security agreements, since the formula utilized always arrives at an option price less than the cost of completing performance under the lease transaction. *See supra* notes 55–57 and accompanying text.

for the entire anticipated economic life of the goods, leaving no anticipated residual value?[67]

Consider this series of hypotheticals:

a. *Substantial Residual Value*

Lessor enters into a one year lease of goods which are anticipated to have a three year economic life. At the end of the year lease, the goods are returned to the lessor. In this case, there is no question that the transaction represents a true lease, and not a security interest. Under the true nature analysis, the lessor retains the right to the residual economic value, in this case a value equal to at least two years of additional use.

b. *Lease to the End of Useful Life*

Lessor enters into a three year lease of goods anticipated to have a three year economic life. This transaction is a disguised security interest, because there is no residual economic value to return to the lessor. The lessor's interest is really only a contingent interest in the goods to secure payment, a security interest.

While it should be theoretically possible to lease to the end of useful life, the true nature analysis requires that the right to the return of the goods represent the lessor's right to some meaningful residual, even when the parties do not currently anticipate that there will be any. Think of it this way: in a purchase, the buyer assumes the risk that the goods will decline in value until they are worth nothing at the point when payment is complete. In fact, virtually every car buyer assumes this risk. Conversely, the buyer, as the holder of the residual value, also has the benefit of any increase in value, even if none is anticipated at the time of the transaction.[68] In a true lease, the lessor retains the residual value of the goods. Could not this theoretically include the right to return of the goods, which may have risen significantly in value, even though no residual value was anticipated at the time the lease began? The lessee is the loser here, because it may be that the lessee could have purchased the goods outright for an amount equal to the lease payments. A true lessee must turn over that residual value at the end of the lease term, regardless of its value.[69]

---

67. Professor Coogan argued that a lease could not exist when there was no residual value: "A lease is basically an arrangement which provides for a payment called rent and which looks toward the return of the leased property to the lessor when it still has some residual value." Coogan, *Some Unconventional Security Devices*, *supra* note 3 at § 4A.07; *Cf. In re* Marhoefer Packing Co., 674 F.2d 1139 (7th Cir. 1982), where the court states:

> An essential characteristic of a true lease is that there be something of value to return to the lessor after the term. Where the term of the lease is substantially equal to the life of the leased property such that there will be nothing of value to return at the end of the lease, the transaction is in essence a sale.

Id. at 1145 (citations omitted).

68. *See generally* Ayer, *Further Thoughts*, *supra* note 3; Ayer, *On the Vacuity*, *supra* note 3; Boss, *Leases & Sales, Ne'er or Where Shall the Twain Meet?*, *supra* note 3.

69. Professor Coogan raised the problem of the Boeing 707, anticipated to have a useful life of 12 years, which actually lasted much longer:

> Had the carrier bought the plane, the installment payments would have paid the purchase price, plus carrying charges. If lessee desires to continue use of the plane he has paid for, he must buy it or renew the lease, in either case at a price to be negotiated with the lessor. The payments were for rent, and the plane belonged to the lessor.

Coogan, *Some Unconventional Security Devices*, *supra* note 3, at § 4A.06[1]. *See also* Coogan, *Is There A Difference?*,

The problem is this: How do we tell the difference between a disguised sale in which all value (both use and the residual) is passing to the lessee, and a true lease with no anticipated residual value, in which the lessee nonetheless assumes the risk that the property will be worth something, and that the residual, whatever its value, must be returned to the lessor?[70]

If one goal of the true nature analysis is to provide a bright-line test that will end the litigation over what is a security interest, and what is a lease, then a standard that does not recognize true leases to the end of useful life is probably preferable. Since I have argued that a meaningful and consistent distinction between a sale and a lease is essential to successful operation of the U.C.C., it will not go against that principle now.[71] However, it should be obvious that lessors who wish to retain the potential benefits of an upside gain in residual value may attempt to evade the effect of this rule by presupposing a useful life beyond that which is currently realistic. By carefully documenting an optimistic useful life, the lessors will presumably assure themselves of protection in cases in which the residual value is really unknown.[72]

c. *Successive Transactions in the Same Goods*

Lessor enters into a one year lease of goods anticipated to have a two year useful life, at the end of which he enters into a one year lease with a different lessee. This is the hard case because the first and second transactions may be identical in every respect, yet the true nature analysis would suggest that the first transaction is a true lease because there is residual value to be reclaimed by the lessor, while the second transaction is really a sale and security interest, because there is no anticipated residual value. Unless the parties use the techniques discussed in Example 2 (b) (lease to the end of useful life), the second transaction cannot be considered a true lease.

d. *Option to Renew to the End of Useful Life*

Assume the same facts as Example 2 (c) above (successive transactions in the same goods), but the original lessee under the one year lease holds an option to renew the lease for an additional one year term. This example leads into the next category of problem transactions, those with options to renew.

---

supra note 3, at §4AA.03[2][c][iv]. Even though Coogan assumes that a lease to the end of useful life is a security interest, this example argues for recognition of a true lease even when no residual value is anticipated at the initiation of the transaction.

70. The Proposed Amendment does not recognize a true lease to the end of useful life. The Proposed Amendment provides that a lease to the end of "economic life" (*see infra* note 159), or a lease with a mandatory renewal to the end of economic life, or an option to renew to the end of economic life for nominal consideration, all create security interests, so long as the obligation of the lessee is not terminable absent full payment. *See Proposed Amendment*, U.C.C. § 1-201(37), *supra* note 3, and *infra* notes 150–89 and accompanying text.

71. *See supra* note 70.

72. *See supra* note 69. Another mechanism which can be used to evade the effect of this rule, as it is codified in the *Proposed Amendment*, U.C.C. § 1-201(37), *supra* note 3, is an option to purchase with no option price specified, when the parties agree that the option price will reflect the actual value at the time the option is exercised. As discussed *infra* notes 150–89 and accompanying text, this will permit the transaction to be considered a true lease for purposes of Article 2A.

3. *Options to Renew*

The option to renew the lease is merely a hybrid of the two previous examples (lease to the end of useful life and option to buy). If the original lease term is not to the end of useful life, then the option to renew is evaluated according to the same standards set forth in subsection 1 above that apply to a purchase option.

a. *The Mandatory Option to Renew*

If the lease requires the lessee to renew, then there are two questions. First, what is the renewal price? Second, is the renewal period to the end of useful life? Since the result is the same whether the option is mandatory or not, each of these possibilities will be examined separately, under the relevant example below.

b. *Option to Renew for Less Than Anticipated Value*

As with options to buy, the relevant question would be: Is the option price adequate compensation for the anticipated use value for the period of renewal? If the answer is no, then the existence of the option to renew may create a security interest from the inception of the transaction, since the lessor is not being adequately compensated for the residual, which in this case is categorized as the remaining use value of the goods at the end of the original lease transaction.[73] In cases when there is still a cognizable residual at the end of the renewal period which returns to the lessor, can the true nature of the transaction be a security interest? The answer must be no. If there is a meaningful residual returning to the lessor, then the transaction must necessarily be a true lease, regardless of the relationship between the renewal price and the anticipated value of the use during the period of renewal. In other words, a renewal price that is below the anticipated value of the renewal term creates a security interest only if the renewal period is to the end of useful life. So long as there is a meaningful residual even after the renewal period is over, the renewal does not create a security interest, either from the inception, or at the point of renewal.

c. *Option to Renew for the Anticipated Value*

A renewal price equal to or greater than the anticipated use value of the goods at the end of the initial lease term does not automatically create a true lease. Again, it is necessary to take a second step and ask if the renewal period is to the end of useful life. If the answer to this question is no, then the original lease is a true lease, and the renewal is also a true lease. In both cases, there is a meaningful residual returning to the lessor.

---

73. The result is the same under the Proposed Amendment. *See Proposed Amendment*, U.C.C. § 1-201(37), *supra* note 3, and the discussion of this provision *infra* notes 150–89 and accompanying text. The process of determining anticipated use value is indistinguishable from the calculation of anticipated residual value in the case of an option to buy. Indeed, the calculation of anticipated residual value will, in most cases, rely upon the anticipated use value of the goods at the end of the initial lease term. The only ways to calculate anticipated residual value are use value and fair market value. Since fair market value is inevitably affected by value of use, these tests would normally reach the same result.

d. *Option to Renew to the End of Useful Life*

In this example, assume that the renewal price is equal to or greater than the anticipated use value of the goods,[74] but the renewal period creates a lease to the end of the useful life. As with renewals for less than the anticipated value of the residual, the renewal to the end of useful life creates a security interest. In other words, every renewal to the end of useful life, regardless of the renewal price, creates a security interest, because there is no meaningful residual to return to the lessor at the end of the transaction.

But at what point does this transaction become a sale and security interest: when the initial lease granting the renewal option to the lessee is entered into, or when the lessee renews the lease for a period which is anticipated to be the end of useful life? Under a true nature analysis, so long as the option price is greater than or equal to the anticipated residual value, the transaction remains a true lease until the option is exercised.[75] This is true whether the option is to purchase or to renew. Until that time, the lessor is still the owner of the residual value, and is being fully compensated for this ownership upon exercise of the option.

But when the renewal period constitutes a lease to the end of the useful life, we have an example of a chameleon lease transaction. It begins life as a true lease, but once the option is exercised, it becomes a lease to the end of the useful life, and, thus, a security interest.[76] This is similar to an option to purchase. When the purchase price is greater than or equal to the anticipated residual value, the initial transaction is a true lease, but upon exercise of the option the transaction is changed to a purchase. In neither case does the exercise of the option result in a recharacterization of the initial transaction: it was and remains a true lease.

On the other hand, if the option price is less than the anticipated residual value of the goods and the renewal is to the end of useful life, the transaction is a security interest from the inception. The original lease appears to leave the lessor a residual, but the disparity between the anticipated value of the residual and the option price means that the residual has actually been transferred to the lessee through the lease payments during the initial term; payment under the renewal option merely completes this transfer. No residual returns to the lessor, and the lessor is not adequately compensated for the transfer of the residual, so the transaction cannot qualify as a true lease.

The effect of an option to renew can thus be determined as follows:

Is the lease renewal period to the end of useful life?

---

74. As discussed in Example 3(b) *supra* text accompanying note 73 (option to renew for less than anticipated value), if there is a meaningful residual at the end of the renewal period, the fact that the renewal was for less than the anticipated use value of the goods during the period of renewal will not change the transaction into a disguised security interest. A true lease exists whenever there is a meaningful residual which returns to the lessor at the end of the transaction.

75. See *infra* notes 149–230 and accompanying text for a discussion of *Proposed Amendment*, U.C.C. § 1-201(37), *supra* note 3.

76. See *infra* notes 170–73 and accompanying text for a discussion of chameleon leases, and the difference between this process and "transubstantiation."

Is the renewal price equal to or greater than the anticipated use value of goods at the point of renewal?

	YES	NO
YES	Original lease is a true lease.	Original lease is a true lease.
NO	Renewal creates a security interest. Transaction is a security interest from the inception.	Renewal is a true lease. Original lease is a true lease. Renewal is a true lease.

E. *The Issues in Personal Property Leasing Reform*

As a result of the confusion over what is and what is not a lease for purposes of applying the U.C.C., the current law of personal property transfer under the U.C.C. is in considerable disarray. Courts have intermingled the U.C.C. and the common law of leasing in their analysis of the distinction between leases and secured transactions under Article 9, and by extending the common law of leasing to include the statutory protections of Article 2.[77] These attempts have not only ignored the literal language of the U.C.C., but have exacerbated the confusion over what constitutes a sale, a lease, or a security interest.

III. Applying Article 9 to a Lease Transaction

A. *The Current Law*

The true nature analysis offers a consistent theory for determining when a transaction is a lease or a security interest, based upon economic allocations effected by the transaction. The guidance provided by the current version of the U.C.C. is far from consistent, particularly as applied by the courts. The confusion surrounding the application of the U.C.C. to leasing arises initially in Article 9. It is impossible to understand the confusion created by judicial interpretation of U.C.C. Section 1-201(37) without a review of the cases that have considered the application of Article 9 to lease transactions. It is important to note at the outset that these cases do not answer the question whether a lease is also subject to Article 2. Since it is possible to create a security interest without finding that the lessor is also a seller, not every security

77. It is beyond the scope of this Article to discuss in detail the application of Article 2 to leases. Suffice it to say that many courts have been motivated to apply Article 2 to leases in an attempt to extend to lessors the protections for buyers under Article 2. As a result, many of the cases that interpret the current definition of security interest do not directly raise Article 9 issues, but rather issues of warranty and unconscionability. Since a finding that a security interest exists presupposes that there has been a sale, courts find their way into Article 2 in many cases by holding that the transaction is a disguised security interest. But a finding that the lessor is a secured party is not necessarily a finding that the lessor is a seller subject to Article 2. *See infra* notes 78–79.

interest disguised as a lease subjects the lessor to liability under Article 2.[78] However, every disguised lease is a security interest, subjecting the lessor to Article 9.[79]

A court determination that a lease is a disguised security interest subject to Article 9 will have a profound impact upon the rights of the lessor. If a court finds that a transaction is a true lease, the filing of a financing statement is not necessary to protect the lessor's interest in the leased goods,[80] and the goods are not subject to the claims of the lessee's creditors.[81] However, the lessor in a disguised lease

---

78. *See* Leasco Data Processing Equip. Corp. v. Starline Overseas Corp., 74 Misc. 2d 898, 346 N.Y.S.2d 288 (1973). It is possible for a security interest to be disguised as a "sale and leaseback" transaction, when the only sale is from the nominal "lessee" to the "lessor." This transaction creates a security interest in previously owned property, with no Article 2 implications for the lessor, since the nominal lessee in this transaction occupies the role of seller, and not the lessor. Most of the cases in this section deal with transactions that are both sales and security interests, and thus are subject to both Article 2 and Article 9. But absent a sale, Article 2 does not govern the transaction, and a determination that a transaction is subject to Article 9 does not automatically trigger application of Article 2. Indeed, even when the court finds that a lease transaction is actually a sale with retention of security interest, the lessor may be a financer who has no Article 2 liability, but nevertheless has all of the obligations of a secured party under Article 9. In this case, Article 9 would apply to the obligation of the lessor/financer, but Article 2 would apply to the obligation of the supplier of the leased equipment. *See, e.g.*, Werber v. Mercedes-Benz of N. Am., 152 Cal. App. 3d 1039, 199 Cal. Rptr. 765 (1984); Atlas Indus., Inc. v. National Cash Register Co., 216 Kan.2d 224, 531 P.2d 41 (1975). *Cf.* Earman Oil Co. v. Burroughs Corp., 625 F.2d 1291 (5th Cir. 1980) (whether the transaction was a true lease or a finance lease, the supplier of goods had sufficiently disclaimed warranty liability under Article 2); CIT Fin. Serv. v. Gott, 5 Kan. 2d 224, 615 P.2d 774 (1980) (court held that supplier, not lessor, had been the seller of the goods for Article 2 purposes).

Under Article 2A, it is possible to create a true finance lease that does not give rise to any warranty liability for the financer, and the liability of the supplier of the goods is passed through the financer to benefit the ultimate lessee. *See Article 2A, supra* note 3, §§ 2A-103(1)(g) (definition of finance lease); 2A-103(1)(x) (definition of supplier); 2A-209 (which provides for the pass-through of liability in a finance lease from the supplier to the lessee); and §§ 2A-211 through 2A-213 (the warranty provisions, that exclude finance leases).

79. *See supra* notes 30–41 and accompanying text, noting that a security interest and a lease cannot exist simultaneously in the same goods in the same transaction. Although it is possible for a secured party to hold a security interest in a lease, the lessor cannot be both a secured party in the goods, and also a lessor. Since a lessor retains the residual economic value in the goods, and a secured party retains only a contingent interest in the goods to secure payment, these transactions are mutually exclusive.

Not every security interest created by the application of U.C.C. § 1-201(37) is a security interest under Article 9. For example, a security interest may be created under Article 8. *See* Coogan, *Some Unconventional Security Devices, supra* note 3, at § 4A.01[5][c][i]. If the intent of the transaction was to create an unconditional obligation on the part of the lessee to pay, coupled with a property interest in the lessor, then the retention of title by the lessor should create a security interest to which Article 9 applies. *Id.*

80. U.C.C. § 9-408 and Official Comment 2. *See Proposed Amendment*, U.C.C. § 1-201(37), *supra* note 3, Official Comment, and *Article 2A*, *supra* note 3, § 2A-101, Official Comment. The drafters of Article 2A did not require public notice for leases which fall within its terms. See *Article 2A, supra* note 3, § 2A-101, Official Comment, which states in part:

> Filing: The lessor is not required to file a financing statement against the lessee or take any other action to protect the lessor's interest in the goods (Section 2A-301). The refined definition of security interest will more clearly signal the need to file to potential lessors of goods. Those lessors who are concerned will file a protective financing statement (Section 9-408).

Id. Ronald DeKoven, the Reporter for Article 2A, stated before the American Law Institute that one of the reasons filing was not required for true leases is that the failure to file would impose a penalty against a lessor which might be inappropriate, including loss of the residual to competing creditors of the lessee. DeKoven explained that optional filing under U.C.C. § 9-408 is obviously encouraged for all long-term leases. ALI Meeting, May 22, 1987, Washington, D.C.

There has been some discussion that much of the confusion over leases and security interests could have been resolved by requiring the filing of a notice under Article 9 for all leases over one year. *See* Coogan, *Some Unconventional Security Devices, supra* note 3, at §§ 4A.01[4][ii] and 4A.06[5]. Although this would not have subjected the leases to Article 9 for all purposes (including, of course, the all-important remedies of Part 5 of Article 9), it would have solved the problem of priority, and left competing secured parties with little to complain about. There is also precedent for treating all leases under Article 9, with special remedies provisions analogous to those applicable to the sale of accounts. *See* Coogan, *Some Unconventional Security Devices, supra* note 3, at 4A.06[4] (discussion of the law of Saskatchwan, which adopts this position). For a discussion of the application of Article 9 to leases, see Coogan & Boss, *U.C.C. Treatment for All Leases, supra* note 3.

81. *See supra* note 46. *Cf.* U.C.C. § 9-203. The debtor's "rights in the collateral" might give the lessee's creditors

transaction must perfect in order to have priority in the leased goods over other creditors of the lessee,[82] and must comply with all of the other provisions of Article 9, including those governing default.[83]

The question whether a lease is in fact a disguised security interest is not raised directly in Article 9. It is cleverly hidden in the definition of security interest in Section 1-201(37). The 1978 version of that definition provides:

> "Security interest" means an interest in personal property or fixtures which secures payment or performance of an obligation. . . . Unless a lease or consignment is intended as security, reservation of title thereunder is not a "security interest" . . . . Whether a lease is intended as security is to be determined by the facts of each case; however, (a) the inclusion of an option to purchase does not of itself make the lease one intended for security, and (b) an agreement that upon compliance with the terms of the lease the lessee shall become or has the option to become the owner of the property for no additional consideration or for a nominal consideration does make the lease one intended for security.[84]

As a result of this provision, and the cases interpreting it, a body of common law has developed that attempts to pinpoint the critical factors which distinguish a true lease from a disguised lease governed by Article 9. The courts have failed to focus upon the true nature of a lease, however, and have contented themselves with devising a laundry list of prohibited provisions, the presence of a sufficient number of which will result in a determination that the lease is a security interest.

It is helpful to look at pre-Code law in interpreting this section. According to pre-Code law, if the lessee paid an amount under the lease that was equal to the fair market value of the goods at the time the lease began, and the lease provided the option or requirement that the lessee purchase the goods, then the lease was considered a conditional sale, and not a true lease.[85] This analysis missed the true nature of a lease, since a true lease may contain an option to purchase the goods, so long as the option price accurately reflects the lessor's residual value in the goods. The current Code provision approves of options in true leases, focusing instead on the option price.[86]

---

rights to the leasehold interest as a general intangible (*see* § 9-106), but not to the residual value of the goods, which in a true lease is retained by the lessor and not the lessee. Note also that most security interests in leases are not given by the lessee, but by the lessor to lessor's creditors, who take a security interest in the lease payments as accounts under § 9-106 (the right to payment for goods leased is an "account") or as chattel paper under § 9-105(1)(d) (A writing that evidences both a monetary obligation and a security interest in or a lease of specific goods is chattel paper.). For an excellent discussion of the problems associated with lease chattel paper, see Boss, *supra* note 31.

82. U.C.C. § 1-201(37). See *infra* notes 131–48 and accompanying text, which explains that a disguised lease is in fact a security interest under Article 9, and U.C.C. § 9-301, which makes clear that an unperfected security interest (including the interest of a lessor in a disguised lease) is subject to the interests of perfected secured creditors in the same collateral, lien creditors, and bulk transferees and other nonordinary course buyers. In other words, an unperfected security interest will take priority in the goods only after perfected security interests in the same goods have been satisfied.

83. U.C.C. § 9-501. The obligation to account to the debtor for proceeds after disposition of the collateral under § 9-504(2), and the debtor's right to demand disposition of the collateral under § 9-505 contrast with the right of a true lessor to retain ownership of the property and still sue for default under the lease. *See supra* text accompanying notes 37–46.

84. U.C.C. § 1-201(37).

85. *See* UNIF. CONDITIONAL SALES ACT § 1(2) (promulgated 1922); *see generally* WILLISTON ON SALES (2d ed.) vol. 1, § 336 (1924); G. GILMORE, *supra* note 14, at § 3.6.

86. If option price in relation to anticipated residual value were always the test, and if courts had not departed from this analysis when leases did not provide a purchase option, the 1978 Code standard would come much closer to focusing

1. *Leases with Options to Purchase*

The Code definition of security interest provides the first set of factors for determining whether or not a lease is a disguised security interest. First, it provides that the existence of an option to purchase does not alone create a security interest. Second, an option to purchase for no consideration or nominal additional consideration creates a security interest.[87]

Does this mean that every lease that contains an option to purchase for nominal consideration is a security interest, regardless of the other terms of the lease that may make clear that the transaction is a true lease? The language of the section suggests that a nominal consideration option is sufficient to create a security interest as a matter of law. However, it is important to recall the introductory phrase of that sentence, which explains that each case must be decided upon its own facts. The comment to this section seems to bolster the conclusion that the existence of such an option is not alone sufficient to create a disguised security interest: "The last two sentences give guidance on the question whether reservation of title under a particular lease is or is not a security interest."[88] The stronger argument is that even a nominal consideration option is not sufficient to transform a transaction that is otherwise a true lease into a security interest. For example, a lease that contains a nominal price purchase option, but which may be terminated at any time by the lessee, should not be considered a security interest.[89]

While the definition in the Code better approximates the true nature analysis than the one existing under common law, if applied mechanically to every lease without further analysis, it still misses the mark. But if we take seriously the Code's preliminary caution that all cases should be decided on their facts, then even cases when the option price is a small dollar amount could be saved from a finding that they are disguised security interests if the option payment reflects the residual value.[90] Most courts have ignored this warning, however, and held that a disguised security interest exists whenever the option price is deemed nominal.[91] In fact, one case held

---

upon the true nature of a lease. Since an option price that reflects anticipated residual value (see *supra* notes 31 and 58) of the goods at the time the option is exercised recognizes the lessor as the owner of the residual value, and compensates her for that value, it focuses attention where it belongs—on the holder of the residual economic value at the completion of the lease. But a test which focuses upon the option price in relation to the purchase price misses this critical point. Also, factors like insurance obligation and risk of loss, which focus upon indicia of ownership other than residual value, miss this point entirely.

87. *See supra* text accompanying notes 48–52.

88. U.C.C. § 1-201, Official Comment 37.

89. *See* Coogan, *Some Unconventional Security Devices*, *supra* note 3, at § 4A.01[2][c][vi][A]; *cf.* Granite Equip. Leasing Corp. v. Acme Pump Co., 165 Conn. 364, 335 A.2d 294 (1973).

90. *See supra* text accompanying notes 61–62. Compare B. CLARK, THE LAW OF SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE ¶ 1.5[3], at 1–26 (1980), where the author states:

> Even if the equipment has little useful life at the end of the lease term, it may not be necessary to file a financing statement to protect the lessor's interest if the option price always bears a resemblance to the fair market value of the property. However, an option price equalling or exceeding the fair market value of the property may be considered nominal if the fair market value is itself nominal.

Id. (citations omitted). This raises the issue of a lease that creates a security interest, not because the option price fails to reflect the anticipated value of the residual, but because the amount of the anticipated residual shows that the lease is one to the end of useful life. *See supra* text accompanying notes 211–14.

91. *See, e.g.*, *In re* J.A. Thompson & Son, Inc., 665 F.2d 941 (9th Cir. 1981); Percival Const. Co. v. Miller & Miller Auctioneers, Inc., 532 F.2d 166 (10th Cir. 1976); *In re* Johnson, 1 Bankr. 689 (Bankr. D. Del. 1979); *In re*

that the two clauses in the last sentence of Section 1-201(37) should be read in reverse order, so that every lease containing a nominal option price is a security interest as a matter of law.[92]

Taking literally the prohibition on nominal price options, the courts have developed three tests[93] to determine whether the option price is nominal: the economic compulsion test[94] (completion of the purchase is the only reasonable alternative for the lessee); the relationship between the option price and the original purchase price;[95] and the relationship between the option price and the value of the goods at the time the option is exercised.[96]

Each of these tests appears to distinguish between transactions in which the lessee has bought both the use value and the residual value of the goods, and those in which the residual still "belongs" to the lessor. Only the last of these three tests focuses properly on the true nature of a lease, consistently reaching the same result as the true nature analysis. Yet many courts have been willing to find a disguised security interest without any inquiry at all into the essential economic issue: to whom does the transaction allocate the residual value in the goods when the transaction is complete?

By analyzing the first test, the economic compulsion test, one can see how a court using this standard could miss the true nature of the transaction. Suppose a lease provided an option to purchase the goods at the end of the lease term for $5000, and it is anticipated that the goods will be worth $10,000. Under the economic

---

Vaillancourt, 7 U.C.C. Rep. Serv. (Callaghan) 748 (Bankr. D. Me. 1970) (decided by referee); *In re* Washington Processing Co., 3 U.C.C. Rep. Serv. (Callaghan) 475 (S.D. Cal. 1966) (decided by referee); *In re* Royer's Bakery, Inc., 1 U.C.C. Rep. Serv. (Callaghan) 342 (Bankr. E.D. Pa. 1963) (decided by referee). *But see In re* Reserves Dev. Corp., 36 U.C.C. Rep. Serv. (Callaghan) 1327 (Bankr. W.D. Mo. 1983); *In re* Cedar Valley Bandag, Inc., 29 U.C.C. Rep. Serv. (Callaghan) 984 (Bankr. N.D. Ga. 1980); *In re* Gehrke Enter., 1 Bankr. 647 (Bankr. W.D. Wis. 1979); *In re* Samoset Assoc., 24 U.C.C. Rep. Serv. (Callaghan) 510 (Bankr. D. Me. 1978); Computer Sciences Corp. v. Sci-Tek, Inc., 367 A.2d 658 (Del. Super. Ct. 1976); Arnold Mach. Co. v. Balls, 624 P.2d 678 (Utah 1981); The issue in these cases is whether a nominal price option creates a security interest as a matter of law, regardless of the other factors (such as a terminable obligation under the lease) which might be considered by a court in making this determination. The first group of cases holds that a nominal price option is determinative. The second group looks to other factors, including the right to terminate the lease without further payment, finding that such factors may create a true lease even in the presence of a nominal price option. *See generally* Coogan, *Some Unconventional Security Devices*, *supra* note 3, at § 4A.01[2][c][vi].

92. *See* Peco, Inc. v. Hartbauer Tool & Die Co., 262 Or. 573, 500 P.2d 708 (1972); *but see In re* Marhoefer Packing Co., 674 F.2d 1139 (7th Cir. 1982) (there was no security interest even when a nominal-price option existed, because the lessee could terminate the lease at any time). *See also supra* text accompanying notes 48–52 and 61–62.

93. *See In re* International Plastics, Inc., 18 Bankr. 583 (Bankr. D. Kan. 1982); *In re* Tucker, 34 Bankr. 257 (Bankr. W.D. Okla. 1983); Peco, Inc. v. Hartbauer Tool & Die Co., 262 Or. 573, 500 P.2d 708 (1972). *See infra* note 104 for a fourth test that looks to the relationship between the option price and the lease payments.

94. *See In re* Vaillancourt, 7 U.C.C. Rep. Serv. (Callaghan) 748, 762 (D. Me. 1970); *In re* Washington Processing Co., 3 U.C.C. Rep. Serv. (Callaghan) 475, 478 (S.D. Cal. 1966).

95. *In re* Oak Mfg., 6 U.C.C. Rep Serv. (Callaghan) 1273 (Bankr. S.D.N.Y. 1969) (decided by referee); *In re* Herold Radio & Elec. Corp., 218 F.Supp. 284 (S.D.N.Y. 1963), *aff'd* 327 F.2d 564 (2d Cir. 1964).

96. *See In re* Marhoefer Packing Co., 674 F.2d 1139 (7th Cir. 1982); *In re* Anton's Lounge & Restaurant, Inc., 40 Bankr. 134 (Bankr. E.D. Mich. 1984); *In re* Clemmons, 37 Bankr. 712 (Bankr. W.D. Mo. 1983); *In re* Loop Hosp. Partnership, 35 Bankr. 929 (Bankr. N.D. Ill. 1983); *In re* Reserves Dev. Corp., 36 U.C.C. Rep. Serv. (Callaghan) 1327 (Bankr. W.D. Mo. 1983); *In re* International Plastics, Inc., 18 Bankr. 583 (Bankr. D. Kan. 1982); *In re* Boling, 13 Bankr. 39 (Bankr. E.D. Tenn. 1981); *In re* Butcher Boy Meat Mkt., Inc., 29 U.C.C. Rep. Serv. (Callaghan) 649 (Bankr. E.D. Pa. 1980); *In re* Samoset Assoc., 24 U.C.C. Rep. Serv. (Callaghan) 510 (Bankr. D. Me. 1978); NBC Leasing Co. v. Stilwell, 334 N.W.2d 496 (S.D. 1983); All-States Leasing Co. v. Ochs, 42 Or. App. 319, 600 P.2d 899 (Or. Ct. App. 1979).

compulsion test, this is a disguised security interest, because the lessee would be a fool not to buy goods worth $10,000 for $5000.[97] This is also a disguised security interest under the true nature analysis, because the lessor must not be the owner of the residual economic value of the goods if he is obligated to sell the goods for substantially less than their anticipated value. Obviously, the ownership of this residual interest has already passed to the lessee in this transaction, and it is a security interest.[98]

As applied by the courts, however, the economic compulsion test has not always reached a correct result for true nature purposes. Suppose the goods have an anticipated market value of $5000 at the end of the lease term (the same as the option price), but the lessee is under an economic compulsion to exercise the option because the actual value of the residual has risen dramatically, or because replacement goods are not readily available, or the disruption in use would be costly to the lessee. Or suppose, for example, that the leased equipment is a neon sign with the name of lessee's business, worth only $5000 to the lessor at the end of the lease term, but replacement of the sign could be obtained only by expending $10,000. In this case, the lessee would willingly exercise the option even if the option price were *more* than the residual value of the goods, and yet the economic compulsion test would find that this lease is a disguised security interest even though the lessor is being completely compensated for the ownership of the residual value. In this example, a true nature analysis would find a true lease, because the option price recognizes the lessor's ownership of this residual economic value, and fully compensates the lessor for it. Again, the question is not whether the lessee has made a good deal and will decide to exercise the option, but whether the lessor has, as an economic matter, already sold the residual to the lessee. Of course, as the lessee evaluates the costs if the option is not exercised, he is indeed under an economic compulsion to exercise the option. However, so long as the lessor receives full value for the ownership interest of the residual value, this should not be considered a security interest, but a true lease.

The point is that the economic compulsion test only reaches the correct result when it is applied to the economic choice which would be made by a reasonable

97. The courts applying this test have used the "no lessee in his right mind" standard: if exercise of the option is too good of a deal for the lessee to pass up, it must be a disguised security agreement and not a lease. *See, e.g., In re* Washington Processing Co., 3 U.C.C. Rep. Serv. (Callaghan) 475 (Bankr. S.D. Cal. 1966) ($1350 option to acquire goods then worth $7500 created a security interest).

98. Rising or falling market value contrary to the expectations of the parties raises an interesting problem with the economic compulsion test. Suppose that the lessor has agreed to an option price of $500, which both parties anticipate will reflect the market value of the goods at the end of the transaction. However, when the time to exercise the option arrives, the goods are actually worth $1000. In this example, the lessee is under an economic compulsion to exercise the option. But it does not change the transaction from a true lease into a disguised security interest. The lessor has really entered into two transactions: the lease of the goods, and an option contract for the sale of the residual value. By setting an option price, the lessor as potential seller retains the risk that the option price will not fully compensate her for the full residual value at the end of the lease term. Unless the option is exercised, the lessor still owns the residual value. And unless the exercise of the option is mandatory, this remains a lease. This is no different from the situation when the lease value of the goods rises during the lease term. The lessor has contracted away the absolute right to take advantage of the rising value, and yet this fact alone does not turn the lease into a disguised security interest. The same is true of falling market value. The lessor who grants a purchase option may be hopeful of receiving the option price as compensation for her residual value, but if there is no absolute right to enforce this option, there is still a true lease. *See supra* notes 31, 58, and text accompanying notes 63–66. For an analysis of these problems in the definition of a lease, see Ayer, *On the Vacuity*, *supra* note 3, at 671–81.

lessee. For example, if the lessee can satisfy his obligation under the lease by exercise of the option, for a price less than completion of the lease obligation, this creates an economic compulsion that is entirely consistent with the true nature of a security interest.[99] Every reasonable lessee will exercise this option, and the transaction is a security interest.

When the economic compulsion test is applied to the relationship between the option price and the value of the goods in the hands of a specific lessee, the result may be inconsistent with a true nature determination. There is, of course, the argument that the value of the goods to the lessee is the only relevant value, and that the market value does not fully reflect the residual value to the lessee.[100] This argument misses the point that exercise of the option requires the lessor to transfer the residual value of the goods for the option payment. If the option payment represents what the lessor would obtain on the market, then the transaction is a true lease. If third parties are willing to pay only $500, then the goods have a residual value of $500. If the lessee is willing to pay more than this, then the payment must be for something other than the residual value of the goods: in this example, that "something else" is a premium that represents the value of the goods in place, or the value of the time associated with disruption. The lessor surely has not previously been compensated for these values by the lease payments, and yet the lessee is under a very real economic compulsion to exercise the option. A lessee who anticipates the cost of this removal or disruption may choose a lease with an option to buy, or a purchase of the goods under a security agreement. But the mere existence of an economic incentive for the lessee to exercise the option in a specific circumstance, whether anticipated by the parties at the outset or not, seems entirely too subjective to turn an otherwise valid true lease into a security interest.[101]

The second test, that looks to the relationship between the option price and the original purchase price, may also lead to incorrect results. The cases applying this method have used a simple mathematical cutoff, finding that an option price that is less than 10%,[102] or less than 25%[103] of the original purchase price is nominal. But without inquiry into the anticipated value of the goods at the time the option is

---

99. *See supra* text accompanying notes 55–57.

100. *See, e.g., In re* Keydata Corp., 18 Bankr. 907 (Bankr. D. Mass. 1982) (equipment unique to lessee's purpose and fair market value to third party would be substantially below purchase price; option is nominal in relation to fair market value to lessee).

101. The same argument applies to the loss of upside risk when the lessor grants an option to buy for a specific price. The relevant inquiry is whether the lessor is receiving what he anticipates the residual will be worth when he grants the option. Although the value of that residual may have risen by the time the option is exercised, the transaction should not be transubstantiated into a security interest. *See supra* notes 63–66 and accompanying text. The same is true of the value of the goods to the specific lessee. Just because the goods unexpectedly become particularly valuable to the lessee, thus creating an economic incentive to exercise the option, does not mean that the transaction was not, and does not remain, a true lease.

102. *See, e.g., In re* Herold Radio & Elec. Corp., 218 F. Supp. 284 (S.D.N.Y. 1963), *aff'd* 327 F.2d 564 (2d Cir. 1964); *In re* Midwest Airmoving Corp., 184 F. Supp. 474 (N.D. Ohio 1959) (conditional sale), *aff'd* 277 F.2d 792 (6th Cir. 1960); *In re* Creditors of Merkel, Inc., 45 Misc. 2d 753, 258 N.Y.S.2d 118 (N.Y. Sup. Ct. 1965) (conditional sale), *rev'd sub nom. In re* Merkel, Inc., 25 A.D.2d 764, 269 N.Y.S.2d 190 (1966).

103. *See, e.g., In re* Wheatland Elec. Prod. Co., 237 F. Supp. 820 (W.D. Pa. 1964); Percival Constr. Co. v. Miller & Miller Auctioneers, Inc., 532 F.2d 166 (10th Cir. 1976).

exercised, this test is irrelevant to the true nature of the lease.[104] For example, suppose computer equipment could be purchased in 1980 for $100,000, and a lessee enters into a lease with an option to buy the equipment in 1986 for $5000. Because computer equipment depreciates rapidly due to galloping obsolescence, the relationship between the option price and the purchase price is really irrelevant. The only relevant question is whether the lessor is being compensated for the anticipated residual value of the goods.[105]

The only test that focuses on the true nature of the transaction is the third test, which looks to the relationship between the option price and the residual value of the goods when the option is exercised. In applying this test, the courts have indeed focused upon the allocation of economic value between the lessor and lessee. If the court finds that the option price permits the lessee to obtain the residual for an amount which is less than the residual value, then this is a disguised security interest. As noted above,[106] this test should focus on the residual as *anticipated* by the parties at the time the lease transaction is entered which grants the option and sets the option price.[107] Any other timing permits the transubstantiation of a lease into a security interest, or the reverse, resulting from an unanticipated change in the market value of the residual during the lease term.

The courts applying this test have not often been confronted with a change in market value.[108] The determination is usually based upon evidence of market value at the time the option was exercised. Assuming that there is no proof of a change in the value of the residual as anticipated when the option price is set, and the time the option is exercised, this test reaches the correct result. But when there has been a change in value, the test should be applied according to the realistic anticipation of the parties when the option price is set. One opinion has addressed this problem in dictum. The case involved an option to renew, not a purchase option, but the dissent noted the importance of a change in value during the lease term.

> This first test which turns on the fair market value of the item at the time of the outright purchase by the lessee is the simplest for courts to apply. It merely involves comparison of two factors which are easily quantified. . . . However, as it is applied by most courts, it is essentially a retrospective determination. Thus, it does not give much guidance to parties wishing to enter into a true lease in a situation where the resale market for the leased items is either unknown or apt to fluctuate widely. The parties themselves would not be able to

---

104. Some courts have looked to the relationship between the lease payments and the option price, possibly presuming that the lease payments reflect some measure of the market value of the goods. *See, e.g., In re* Medical Oxygen Serv., 36 Bankr. 341 (Bankr. N.D. Ga. 1984); *In re* B. A. Giancaterin & Assoc., 9 Bankr. 26 (Bankr. W.D.N.Y. 1981). These cases suffer from the same difficulty as those cited in the text which look to the relationship between the original purchase price and the option price.

105. *See supra* note 58 and text accompanying notes 63–66.

106. *See supra* text accompanying notes 54–62 on the correct evaluation of the option price.

107. *See supra* text accompanying notes 63–66.

108. *See supra* notes 58 and 96. *See also In re* Pacific Sunwest Printing, 6 Bankr. 408 (Bankr. S.D. Cal. 1980); *In re* Universal Medical Servs., Inc., 8 U.C.C. Rep. Serv. (Callaghan) 614 (Bankr. E.D. Pa. 1970) (decided by referee); *In re* Alpha Creamery, 4 U.C.C. Rep. Serv. (Callaghan) 794 (Bankr. W.D. Mich. 1967) (decided by referee); *In re* Washington Processing Co., 3 U.C.C. Rep. Serv. (Callaghan) 475 (Bankr. S.D. Cal. 1966) (decided by referee); Western Enter. v. Arctic Office Machs., Inc., 667 P.2d 1232 (Alaska 1983); Granite Equip. Leasing Corp. v. Acme Pump Co., 165 Conn. 364, 335 A.2d 294 (1973); Peco, Inc. v. Hartbauer Tool & Die Co., 262 Or. 573, 500 P.2d 708 (1972); Davis Bros. v. Misco Leasing, Inc., 508 S.W.2d 908 (Tex. Civ. App. 1974).

> determine the nature of their relationship. Rather, whether they had indeed *leased* the items would turn on the market price of the goods at the end of the term or a court's estimate of that figure in the event of interim default. This difficulty may best be resolved by comparing the option price to the estimated resale value of the property as of the time the transaction was entered into instead of comparing it to the actual market value when the option is exercised.[109]

The court, recognizing the important guidance provided by a test that can be applied prospectively, correctly noted that the true nature of the transaction must be determined as of the time the option price is set in the lease agreement. The few courts that have addressed a difference between anticipated and actual residual value have generally reached a consistent result.[110]

In *Appleway Leasing, Inc. v. Wilken*,[111] the court dealt with a disparity between the anticipated and actual fair market value of the leased goods. The lease contained an option specifying that the anticipated fair market value of the goods was $1900. The court considered the option nominal when the evidence showed that the actual fair market value was between $9000 and $10,000. There was no evidence that this disparity was the result of an unanticipated change in market value; the court correctly discerned that the anticipated residual value set by the parties was an attempt to evade a finding that the lease was a security interest. The court was not fooled by this provision, and correctly found that the lease was one intended for security.[112]

Another case that dealt with this issue is *In re Celeryvale Transportation, Inc.*[113] In *Celeryvale*, the option required payment of the fair market value of the equipment at the end of the lease, as established by independent appraisers. Although it does not seem under the true nature analysis that this factor alone could create a security interest, the court went to great lengths to take evidence on the fair market value of the equipment. An appraiser testified on the resale value of comparable equipment, as well as the increase in the cost of new equipment during the lease term, which resulted in a concomitant rise in the price of used equipment. Based upon this

---

109. McGalliard v. Liberty Leasing Co. of Alaska, 534 P.2d 528, 538 (Alaska 1975) (Boocherer, J., dissenting) (emphasis in original) *overruled* Western Enters., Inc. v. Arctic Office Machs., Inc., 667 P.2d 1232 (Alaska 1983). See the treatment of this timing under the Proposed Amendment to § 1-201(37), *infra* at notes 149–230 and accompanying text.

110. *See, e.g.*, *In re* Samoset Assoc., 24 U.C.C. Rep. Serv. (Callaghan) 510 (D. Me. 1978) (option that permitted purchase for greater of fair market value at the time of exercise or 10% of original acquisition cost could not be deemed nominal in the absence of evidence as to the actual fair market value); *In re* Universal Medical Servs., Inc., 325 F.Supp. 891 (E.D. Pa. 1970) (option price of 10% of original selling price closely approximated the market value of the goods at the end of the lease term, and was therefore not nominal); *In re* Boling, 13 Bankr. 39 (Bankr. E.D. Tenn. 1981) (option to purchase for estimated fair market value at end of lease term, which was specified in lease as 10% of original selling price, was roughly equivalent to the actual fair market value, and was not nominal); Horton v. Dental Capital Leasing Corp., 649 S.W.2d 655 (Tex. Ct. App. 1983) (option that specified the purchase price to be the fair market value at the time of exercise was not nominal). A similar option was at issue in *In re* Holywell Corp., 51 Bankr. 56 (Bankr. S.D. Fla. 1985). In that case, the option was to be the greater of the unrecovered original cost of the leased goods or the market value at the time the option was exercised. The evidence showed that the market value was 99% of the purchase price, or $7.7 million. The court correctly determined that these were true leases.

111. 39 Or. App. 43, 591 P.2d 382 (1979).

112. *Id.* at 46–47, 591 P.2d at 383–84.

113. 44 Bankr. 1007 (Bankr. E.D. Tenn. 1984), *aff'd*, 822 F.2d 16 (6th Cir. 1987).

evidence, the court held that the option price was not nominal, and the transactions were true leases.[114]

2. *Leases Without Purchase Options*

As far as the courts have strayed from the true nature analysis when an option price exists, they are even further from the mark when there is no option at all. Under Section 1-201(37), it is possible even in the absence of a purchase option to find that a lease is a disguised security interest. The only remaining guidance in Section 1-201(37) are the statements that:

(1) unless the lease is intended to create a security interest, the reservation of title is not a "security interest";

(2) whether a lease is intended as security is to be determined by the facts of each case; and

(3) an option alone does not create a security interest.[115]

But what other factors will create a security interest? Article 9 defines a security interest broadly, looking to the intent of the transaction, regardless of the terms used by the parties to describe it.[116]

The scope provision of Article 9 explains: "[T]his Article applies (a) to any transaction (regardless of its form) which is intended to create a security interest in personal property or fixtures including goods . . . ."[117] Subsection 2 states that the Article will apply to a security interest created by a lease transaction.[118] Comment 1 to this section refers to the definition of security interest in Section 1-201(37), and states: "The conditional sale or bailment-lease, for example, is not prohibited; but even though it is used, the rules of this Article govern."[119]

---

114. *Id.* at 1015. The opinion of the court raises the very difficult problem of the interaction between an option price which is nominal but not a disguised security interest because the actual residual value is nominal, and a lease to the end of useful life. In theory, a lease with an option to purchase for $10 at the end of the lease term, when goods are worth $10 at the end of the term, should not create a security interest because of a nominal option price. But it *may* create a disguised security interest because the lease is in fact a lease to the end of useful life. *See* discussion *supra* notes 67–72 and accompanying text. In *Celeryvale*, the court said:

> An option to purchase at the end of the lease for the fair market value of the leased goods is consistent with a true lease, but does not automatically save the lease from being a lease intended for security. *In re* Coors of the Cumberland, Inc., 19 Bankr 313, 33 U.C.C. Rep. Serv. (Callaghan) 241 (Bankr. M.D. Tenn. 1982); *In re* Winston Mills, Inc., [6 Bankr. 587, 598 (Bankr. S.D.N.Y. 1980)] . . . .
>
> The proof may show that the goods will have no market value at the end of the lease and will be abandoned or transferred to the lessee for no additional payment or for a miniscule payment that is clearly nominal consideration. This is likely to be true for goods that are near the end of their useful life and have little or no salvage value. In such a situation the option to purchase for fair market value is a sham that does not prevent the lease from being a lease intended for security.

Id. at 1013–14. *See also In re* Berge, 32 Bankr. 370 (Bankr. W.D. Wis. 1983); Atlas Indus., Inc. v. National Cash Register Co., 216 Kan. 213, 531 P.2d 41 (1975). For treatment of this problem under the Proposed Amendment, see *infra* text accompanying notes 149–230.

115. U.C.C. § 1-201(37).

116. *See* Leasing Serv. Corp. v. American Nat'l Bank & Trust Co., 19 U.C.C. Rep. Serv. (Callaghan) 252, 258 (D.N.J. 1976). See also *supra* text accompanying notes 14–18, discussing "intent" which notes that characterization of the transaction is unaffected by what label the parties give to it.

117. U.C.C. § 9-102(1).

118. U.C.C. § 9-102(2).

119. U.C.C. § 9-102, Official Comment 1.

How then have the courts distinguished between a lease and a disguised security interest when the option price is not nominal, or there is no option at all? Rather than focusing upon any of the economic distinctions between these two transactions, the courts have developed a laundry list of factors they rely upon to find that a lease is subject to Article 9. There is no one litmus test; the courts tend merely to look at the lease agreement, total up the number of offending terms, and call the lease a security interest.

Factors considered by the courts to create a disguised security interest include:

(1) whether the total rental exceeds the fair market value of the property at the time the lease is entered into,[120]

(2) whether the lessee has an obligation to insure the equipment against loss,[121]

(3) whether the lessee has an obligation to pay the full lease amount regardless of loss of the property, or loss of its use,[122]

(4) whether the lessee is unable to terminate his obligations under the lease by return of the property,[123]

(5) whether the lessee has an obligation to indemnify the lessor from liability arising in connection with the goods,[124]

(6) whether the lessee has an obligation to pay taxes on the property,[125]

(7) whether future rent is accelerated in the event of default,[126]

(8) whether the value of the property to the lessee in place vastly exceeds its value upon removal to the lessor,[127]

(9) whether there is an exclusion of all warranties on the property,[128] and

(10) whether the lessor is the original owner, manufacturer, or supplier of the property that is the subject of the lease.[129]

Each of these factors is a traditional indicium of ownership, tending to make the lease more like a security interest and less like a true lease. But the courts have been unwilling to define this distinction in a more analytical way by focusing upon the relative economic interests of the lessor and the lessee in the property. If the lessee has primary economic interest in the leased property, rather than an interest only in its use, while the lessor has primary economic interest in the lease obligation, rather

120. *See* Leasing Serv. Corp. v. American Nat'l Bank & Trust Co., 19 U.C.C. Rep. Serv. (Callaghan) 252 (D.N.J. 1976); *In re* Francis, 42 Bankr. 763 (Bankr. E.D. Mo. 1984).

121. *See, e.g.*, Leasing Serv. Corp. v. American Nat'l Bank & Trust Co., 19 U.C.C. Rep. Serv. (Callaghan) 252 (D.N.J. 1976); *In re* Brookside Drug Store, Inc., 3 Bankr. 120 (Bankr. D. Conn. 1980).

122. *See, e.g., In re* Clemmons, 37 Bankr. 712 (Bankr. W.D. Mo. 1984); *In re* Brookside Drug Store, Inc., 3 Bankr. 120 (Bankr. D. Conn. 1980).

123. *See In re* Smith Management, Inc., 8 Bankr. 346 (Bankr. W.D. Wis. 1980).

124. *See, e.g.*, Leasing Serv. Corp. v. American Nat'l Bank & Trust Co., 19 U.C.C. Rep. Serv. (Callaghan) 252 (D.N.J. 1976).

125. *See, e.g., In re* Tillery, 571 F.2d 1361 (5th Cir. 1978).

126. *See, e.g., In re* Pomona Valley Inn, 4 U.C.C. Rep. Serv. (Callaghan) 893 (C.D. Cal. 1967); Leasing Serv. Corp. v. American Nat'l Bank & Trust Co., 19 U.C.C. Rep. Serv. (Callaghan) 252 (D.N.J. 1976).

127. *See, e.g.*, McGalliard v. Liberty Leasing Co. of Alaska, 534 P.2d 528 (Alaska 1975), *overruled by* Western Enters., Inc. v. Arctic Office Machs., Inc., 667 P.2d 1232 (Alaska 1983).

128. *See, e.g.*, Lease Fin., Inc. v. Burger, 40 Colo. App. 107, 575 P.2d 857 (1977).

129. *See, e.g.*, Woods-Tucker Leasing Corp. v. Hutcheson-Ingram Dev. Co., 626 F.2d 401 (5th Cir. 1980), *opinion withdrawn by* 642 F.2d 744 (5th Cir. 1981); Executive Fin. Servs. v. Pagel, 238 Kan. 809, 715 P.2d 381 (1986). *See generally In re* Brookside Drug Store, Inc., 3 Bankr. 120 (Bankr. D. Conn. 1980) (listing sixteen factors considered in determining whether a transaction is a true lease or a security interest).

than payment for use coupled with residual value, then the lease is a disguised security interest.

For example, parties may agree in the lease that the lessee will be obligated to insure or pay taxes on the leased goods. This is an allocation of responsibility that does not affect the lessor's position as the holder of the residual economic value. Under a true nature analysis, such factors have no bearing on whether the lease is a disguised security interest. The same is true of the value of the goods in place. If the lessor is concerned that the goods are more valuable to the lessee than to the lessor, then there are several things that the lessor can do. The lessor can charge a higher rent, or place a higher cost on the exercise of the option. Neither of these choices results in a security interest—so long as the lessor obtains the anticipated value for the exercise of the option, the transaction remains a true lease. As an alternative, the parties can structure the transaction which transfers this residual value to the lessee—that is, the parties can enter into a sale transaction with a retention of a security interest. But the value of the goods in place does not alone determine the ownership of the residual value.[130]

3. *The Effect of Calling a Lease a Disguised Security Interest*

The importance of subjecting a lease to the provisions of Article 9 takes two forms: the necessity of filing to perfect a security interest in the leased goods and the obligation of the lessor to comply with Part 5 of Article 9 upon repossession of the leased property. In addition, a finding that a lease is in fact a sale may subject the agreement to attack under state usury laws.[131]

The first issue should no longer present major difficulties for lessors. Every lessor, even one who would protest that the lease is not a disguised security agreement, should file a financing statement. This is cheap insurance to protect the leased goods, and will not affect the characterization of the transaction as outside of Article 9.[132] Section 9-408 contemplates just such a filing:

> A . . . lessor of goods may file a financing statement using the terms . . . "lessor," "lessee" or the like instead of the terms specified in Section 9-402. The provisions of [Part 4 of Article 9] shall apply as appropriate to such financing statement but its filing shall not of itself be a factor in determining whether or not the . . . lease is intended as security (Section 1-201(37)). However, if it is determined for other reasons that the . . . lease is so intended, a security interest of the . . . lessor which attaches to the . . . leased goods is perfected by such filing.[133]

Comment 2 to that section provides:

---

130. See *supra* text following note 98 for an example of a true lease when the goods in place have a greater value than the market value. This factor does not change the fact that the lessor still owns the market value of the goods at the end of the lease, absent an option to purchase for less than their residual value on the market. This test is inappropriate for the same reasons as the "economic compulsion" test which has been applied to purchase options. *See supra* text accompanying notes 97–101.

131. *See* Bell v. Itek Leasing Corp., 262 Ark. 22, 555 S.W.2d 1 (1977).

132. But see *infra* note 135 discussing the risk of filing in those states that have not enacted this amendment.

133. U.C.C. § 9-408.

> If a lease is actually intended as security . . . , this Article applies in full. But this question of intention is a doubtful one, and the lessor may choose to file for safety even while contending that the lease is a true lease for which no filing is required. This section authorizes filing with appropriate changes of terminology, and without affecting the substantive question of classification of the lease. If the lease is a true lease, none of the provisions of the Article is applicable to the lease as an interest in the chattel.[134]

Thus, any argument over the lessor's priority in the leased goods can be resolved by filing a financing statement, and the filing of such a statement cannot be considered by the court in determining whether a lease is a security interest.[135] Of course, the existence of a filing under Section 9-408 does not protect the lessor from a finding that the lease is a security interest, when other factors support the conclusion.[136] If a court finds that a lease is a security interest, the lessor's failure to have filed a financing statement will defeat the lessor's priority in the property.[137]

Even filing a financing statement under Section 9-408 offers only limited protection for a lessor. While a precautionary filing will maintain the lessor's priority in the event that the court finds that the transaction creates a security interest,[138] it does not excuse the lessor from complying with the other obligations of a secured creditor. For example, if the court finds that the lease is a security interest, the lessor is required to comply with the default provisions of Article 9.[139] The lessee will retain the right to redeem the property under Section 9-506,[140] and the lessee will be freed from any obligation to pay a deficiency if the lessor fails to comply with Section 9-504.[141]

Obviously, these issues are important in bankruptcy. A secured party disguised as a lessor who fails to file will be deemed an unsecured creditor as to the leased goods under the strong-arm powers of the trustee.[142] And the trustee may pursue rights under Section 9-507 when a lessor fails to comply with the default provisions

---

134. U.C.C. § 9-408, Official Comment 2.

135. *See* Rollins Communications, Inc. v. Georgia Inst. of Real Estate, Inc., 140 Ga. App. 448, 451, 231 S.E.2d 397, 399 (1976). Note, however, that this section is part of the 1972 amendments to Article 9, and has not been adopted in many states. *See, e.g.*, Mo. REV. STAT. §§ 400.9–408 (1986) (additional filing requirements). Without this amendment, the filing of a financing statement is not without risk. Where this amendment has not been adopted, there is case authority that the filing of a security interest may be considered as one factor in finding that a lease is a security interest. *See* Bell v. Itek Leasing Corp., 262 Ark. 22, 25, 555 S.W.2d 1, 3 (1977); Computer Sciences Corp. v. Sci-Tek, Inc., 367 A.2d 658, 660–61 (Del. Super. 1976); BVA Credit Corp. v. Fisher, 369 So. 2d 606, 609 (Fla. App. 1978) *cert. den.* Fisher v. BVA Credit Corp., 370 So. 2d 459 (Fla. 1979). Other courts addressing this issue have applied the reasoning of § 9-408 even in the absence of its adoption. *See, e.g.*, American Standard Credit, Inc. v. National Cement Co., 643 F.2d 248 (5th Cir. 1981).

136. *See, e.g.*, *In re* Sprecher Bros. Livestock & Grain, Ltd., 58 Bankr. 408 (Bankr. D.S.D. 1986).

137. *See In re* Pacific Sunwest Printing, 6 Bankr. 408, 415 (Bankr. S.D. Cal. 1980); *In re* Gehrke Enters., 1 Bankr. 647 (Bankr. W.D. Wis. 1979).

138. *See In re* Vintage Press, Inc., 552 F.2d 1145 (5th Cir. 1977); *In re* Butcher Boy Meat Mkt., Inc., 29 U.C.C. Rep. Serv. (Callaghan) 649 (Bankr. E.D. Pa. 1981).

139. *See, e.g.*, Clune Equip. Leasing Corp. v. Spangler, 615 S.W.2d 106 (Mo. App. 1981); General Elec. Credit Corp. v. Castiglione, 19 U.C.C. Rep. Serv. (Callaghan) 705 (N.J. Super. 1976).

140. *See* H.M.O. Sys., Inc. v. Choicecare Health Servs., 665 P.2d 635 (Colo. App. 1983); U C Leasing, Inc. v. Laughlin, 96 Nev. 157, 606 P.2d 167 (1980).

141. *See, e.g.*, U C Leasing, Inc. v. Laughlin, 96 Nev. 157, 606 P.2d 167 (1980).

142. *See* 11 U.S.C. § 544(a) (1982 & Supp. III 1985).

of Article 9.[143] In addition, the trustee will have a longer period to decide whether to retain the goods if the transaction is deemed a security agreement than if the court finds it to be a true lease.[144] Finally, a true lease may give rise to an adequate protection obligation that is greater than that obtainable by a secured creditor.[145] And, of course, this distinction will also be relevant if the lessor becomes a debtor in bankruptcy, since the rights of a lessor are different from the rights of a secured party, and this distinction will be reflected in the lessor/secured party's bankruptcy estate.[146]

The issue whether a transaction is a security interest or a true lease has generated litigation far in excess of its relative importance to Article 9.[147] A consistent test that looks to the relative economic interests of the parties would serve the purpose of reflecting the true nature of a leasing transaction. But more importantly, it would also permit the parties to this transaction to avoid needless litigation over an issue the determining factors of which are resolved at the time the transaction takes place.[148] At present, the answer to the question "what makes a lease a disguised security interest?" is not discernable from the most careful reading of the cases that attempt, feebly, to answer it.

B. *The Proposed Amendment to Section 1-201(37)*

As a result of the myriad problems in applying the current version of Section 1-201(37), the National Conference of Commissioners on Uniform State Laws and the American Law Institute have promulgated an amendment to Section 1-201(37) to identify the factors important in distinguishing secured transactions arising in financed sales from true leases.[149]

1. *An Overview of the Proposed Amendment*

As a part of Article 2A, the drafters propose an amendment of Section 1-201(37) to clarify when a lease is a disguised security agreement. The Proposed Amendment provides some additional distinctions[150] between true leases which are not intended

---

143. U.C.C. § 9-507. *See In re* Chisholm, 54 Bankr. 52 (Bankr. M.D. Fla. 1985). Note that even a disguised lessor who files a protective financing statement is not immune from the application of the provisions of Part 5 of Article 9.

144. *See* 11 U.S.C. § 365 (1982 & Supp. III 1985); *In re* Loop Hosp. Partnership, 35 Bankr. 929 (Bankr. N.D. Ill. 1983).

145. For an excellent discussion of the different rights of a lessor and a secured party in bankruptcy, see L. LoPucki, Strategies for Creditors in Bankruptcy Proceedings §§ 7.2, 7.4, 12.7.1, 13, 16.3.2, and 17 (1985).

146. See *In re* OPM Leasing Servs., Inc., 23 Bankr. 104 (Bankr. S.D.N.Y. 1982). See discussion of this case in B. Clark, The Law of Secured Transactions Under the Uniform Commercial Code ¶ S1.5[3], at § 1-19 (1980 & Supp. 1987).

147. The cases on this issue are digested in the U.C.C. Rep. Serv. Digest at ¶¶ 1201.37(7), 9102.17, and 9408. The § 1-201(37) annotation alone runs 85 pages as of the date of this writing, and virtually every conceivable leasing provision is represented there. Obviously, whatever the intent of the courts in resolving this issue, the attempted solution is not working.

148. There is a superb discussion of this issue in B. Clark, The Law of Secured Transactions Under the Uniform Commercial Code ¶ 1.5, at 1-22 to 1-33 (1980). *See also* Coogan, *Some Unconventional Security Devices*, *supra* note 3.

149. See *supra* notes 19–21 for the promulgation process.

150. Under the current version of U.C.C. § 1-201(37), there are few explicit guidelines. First, whether a lease is intended as security is to be decided by the facts of each case. Second, the existence of an option to purchase does not alone create a security interest. Third, an option to purchase for no consideration or nominal additional consideration makes the lease a security interest as a matter of law. Fourth, the reservation of title alone does not create a security interest. *See* U.C.C. § 1-201(37), and text accompanying notes 78–148.

as security interests, and those which are disguised security interests.[151] These distinctions focus upon the economic reality of the transaction.[152] In essence, the test provided by this amendment is a true nature analysis: if the residual value of the leased goods is passing to the lessee for no payment or nominal payment, the lease is a disguised security interest, but if the lessor retains the residual value of the goods absent payment by the lessee of an amount equal to the fair market value of the residual interest, then the lease is not a security interest.

This is an appropriate focus for the distinction between these two types of transactions, and it is consistent with other existing rules under the U.C.C. For example, under Article 9, surplus value after the sale of repossessed security goes to the debtor, who is the owner of the residual value notwithstanding the existence of a security interest, while the lessor may retain any surplus value upon repossession of true leased goods.[153]

The Proposed Amendment to Section 1-201(37) retains the proviso of the original section that each case is to be determined on its own facts. It deletes, however, any reference to the intention of the parties.[154] The Official Comment to the Proposed Amendment states:

> Reference to the intent of the parties to create a lease or security interest has led to unfortunate results. In discovering intent, courts have relied upon factors that were thought to be more consistent with sales or loans than leases. Most of these criteria, however, are as applicable to true leases as to security interests. Examples include the typical net lease provisions, a purported lessor's lack of storage facilities or its character as a financing party rather than a dealer in goods. Accordingly, amended Section 1-201(37) deletes all reference to the parties' intent.[155]

The Proposed Amendment does not leave courts to their task with only the facts of each case to guide them. The Amendment offers some specific guidelines. It creates a two-step test for finding a disguised security interest. The test focuses first upon the obligation of the lessee under the lease. If the consideration paid by the lessee for the term of the lease is not subject to termination by the lessee (for example, if the lessee continues to owe the obligation of payment under the lease even if the goods are returned, or they become inoperative), then the transaction passes the first hurdle for identification of a security interest.[156] This provision is intended to

---

151. *Proposed Amendment* U.C.C. § 1-201(37), *supra* note 3.

152. *See id.* The Official Comment states, "All of these tests focus on economics, not the intent of the parties."

153. *See* U.C.C. § 9-504(2) and *supra* text accompanying notes 30–41.

154. See *supra* text accompanying notes 84–85 for the source of the intent language, and *supra* text accompanying notes 14–18 for the difficulties this language has created.

155. *Proposed Amendment*, U.C.C. § 1-201(37), *supra* note 3, Official Comment.

156. The relevant portion of the Proposed Amendment provides:

> Whether a transaction creates a lease or security interest is determined by the facts of each case; however, a transaction creates a security interest if the consideration the lessee is to pay the lessor for the right to possession and use of the goods is an obligation for the term of the lease not subject to termination by the lessee, and
>
> (a) the original term of the lease is equal to or greater than the remaining economic life of the goods,
>
> (b) the lessee is bound to renew the lease for the remaining economic life of the goods or is bound to become the owner of the goods,
>
> (c) the lessee has an option to renew the lease for the remaining economic life of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement, or

undercut decisions that held that a lease which could be terminated at any time was nonetheless a disguised security interest.[157] The comment explains:

> The second paragraph of the new definition is taken from Section 1(2) of the Uniform Conditional Sales Act (act withdrawn 1943), modified to reflect current leasing practice. Thus, reference to case law prior to this Act will provide a useful source of precedent. . . . Whether a transaction creates a lease or a security interest continues to be determined by the facts of each case. The second paragraph further provides that a transaction creates a security interest if the lessee has an obligation to continue paying consideration for the term of the lease, if the obligation is not terminable by the lessee (thus correcting early statutory gloss . . .) and if one of four additional tests is met.[158]

After determining that the lessee's obligation is not terminable, a second step must be satisfied in order to find a security interest. Under this test, one of the following factors must also be present:

(a) the original term of the lease is equal to or greater than the economic life of the goods,[159]

(b) the lessee is bound to renew the lease for the remaining economic life of the goods, or is bound to become the owner of the goods,

(c) the lessee has the option to renew the lease for the economic life of the goods for nominal or no additional consideration upon compliance with the lease agreement, or

(d) the lessee has the option to become the owner of the goods for nominal or no additional consideration upon compliance with the lease agreement.[160]

Each of these elements presents a different example of the factors that will result in the transaction being deemed a security interest from the inception of the transaction. First, if the original lease is for the remaining economic life of the goods, the transaction is a security interest. The Proposed Amendment does not sanction a true lease to the end of economic life, unless the lessee is permitted under the lease to terminate the transaction. "Economic life" is determined, according to the Proposed Amendment, as of the time that the transaction is entered into.[161] As discussed above, this is the appropriate point for making this determination, and permits the parties to create a true lease transaction which will not be undone by subsequent events beyond their control.[162]

Second, if the lessee is obligated under the lease to renew for the remaining economic life, then the transaction is similarly considered a security interest from its

---

(d) the lessee has an option to become the owner of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement.

Proposed Amendment, U.C.C. § 1-201(37), *supra* note 3.

157. *See, e.g., In re* Royer's Bakery, Inc., 1 U.C.C. Rep. Serv. (Callaghan) 342 (Bankr. E.D. Pa. 1963), and *supra* note 49.

158. *Proposed Amendment*, U.C.C. § 1-201(37), *supra* note 3, Official Comment, (citations omitted) *citing In re* Royer's Bakery, Inc., 1 U.C.C. Rep. Serv. (Callaghan) 342 (Bankr. E.D. Pa. 1963).

159. Economic life of the goods is to be determined as of the time the transaction is entered into. *See Proposed Amendment*, U.C.C. § 1-201(37)(y), *supra* note 3. See *supra* text accompanying notes 67–72 for a discussion of leases to the end of economic life.

160. *Proposed Amendment*, U.C.C. § 1-201(37), *supra* note 3.

161. *Proposed Amendment*, U.C.C. § 1-201(37)(y), *supra* note 3.

162. *See supra* text accompanying notes 67–72.

inception.[163] The same is true if the option is really no option at all, but requires the lessee to acquire the property.[164] Both of these terms create a transaction in which the nominal "lessee" is contractually bound to purchase the residual, which is properly treated as a sale and security interest.

Third, if the lessee has the option to renew for the remaining economic life, and the price for the renewal is nominal, then the initial transaction is not a true lease.[165] "Nominal price" is defined to exclude a rent which is agreed in the lease to be the fair market rent when the option is exercised.[166] So, for example, if the lease grants the lessee an option to renew for the remaining economic life but specifies that the renewal price will be determined at the time of renewal, and will be the fair market rent at that time, then the lease is not a disguised security agreement.[167]

Finally, if the lease contains an option to purchase the goods for no consideration or nominal consideration, the lease is a security interest.[168] Again, "nominal" is defined in the Proposed Amendment to exclude a transaction in which the parties stipulate that the option price will be fair market value, to be determined at the time the option is performed.[169]

It is essential to remember that the two prong test provided by the Proposed Amendment only answers the question whether the original lease transaction was really a disguised security interest. It does *not* answer the question whether the transaction ceased to be a true lease as a result of the exercise of an option. In other words, the Proposed Amendment tells us whether the initial transaction is a security interest. It does not, by its terms, directly address the problem of the chameleon lease.[170]

---

163. *Proposed Amendment*, U.C.C. § 1-201(37)(first b), *supra* note 3. *See id.*, Official Comment, *citing In re* Gehrke Enters., 1 Bankr. 647 (Bankr. W.D. Wis. 1979).

164. *Proposed Amendment*, U.C.C. § 1-201(37)(first b), *supra* note 3. *See supra* text accompanying note 54.

165. *Proposed Amendment*, U.C.C. § 1-201(37)(first c), *supra* note 3. *See supra* text accompanying notes 67–72.

166. *Proposed Amendment*, U.C.C. § 1-201(37)(x)(i), *supra* note 3.

167. *Id.*, Official Comment, citing *In re* Celeryvale, 44 Bankr. 1007 (Bankr. E.D. Tenn. 1984) discussed *supra* text accompanying notes 113–14.

168. *Proposed Amendment*, U.C.C. § 1-201(37)(first d), *supra* note 3.

169. *Proposed Amendment*, U.C.C. § 1-201(37)(x)(ii), *supra* note 3.

170. The chameleon lease must be distinguished from the transubstantiation process criticized in *supra* text accompanying notes 63–65. In the chameleon lease, the actions of the parties to the transaction bring about the change in nature. By renewing the lease to the end of useful life, the parties have altered the character of their relationship from a true lease to a security interest. The prior transaction is not recharacterized, but its nature changes as a result of the subsequent actions of the parties.

In the transubstantiation process discussed above, a change in the market value of the residual, beyond the control of the parties, resulted in the change from a true lease to a security interest (or the reverse), if the transaction is not evaluated based upon the reasonable prediction of the parties at the outset. Since the parties cannot control the market value of the residual, it is inherently unfair for the characterization of their transaction to change based upon factors wholly outside their control. It is preferable to judge this transaction from the point when the relationship was initiated, and not to subject it to differing treatment as market values rise and fall.

On the other hand, in the chameleon lease, there is no inherent unfairness in recharacterizing the transaction based upon a changed relationship initiated by the parties themselves. Of course, as Professor Charles W. Mooney, Jr., noted in his presentation on Article 2A at the ABA Convention, New York City, August 12, 1986, this change may occur at a point in a continuing relationship when the parties are not aware of having altered their transaction. Professor Mooney used the example of a month-to-month lease of consumer goods, with a monthly renewal option. At some point, the renewal of this agreement for an additional month is a renewal to the end of useful life. The parties would not normally be cognizant of the fact that this renewal is the economic equivalent of a purchase of the residual by the lessee. And yet, under the Proposed Amendment, this becomes a lease to the end of useful life (assuming no right to terminate during the month), and as a result it is no longer a true lease.

The easiest example of this distinction is the purchase option. If a purchase option passes the test of the Proposed Amendment—that is, it is not mandatory, and it is not for nominal consideration—then the original transaction is a true lease. Of course, when the option is exercised, the transaction is no longer a true lease: at that point, it becomes a sale. But the subsequent sale does not change the characterization of the original lease—it was a true lease until the moment the option was exercised. On the other hand, if the sale option is for nominal value, or is mandated by the agreement, then the transaction is deemed a security interest from its inception.

Although more difficult to grasp, the same is true of an option to renew. If the lessee is bound to renew for the remaining economic life, or has the option to renew for the remaining economic life for nominal consideration, then the original transaction is a security interest. If neither of these clauses exist (or if the transaction is terminable by the lessee), then the original transaction is a true lease, and nothing that the parties do subsequently will result in a retroactive recharacterization of the original transaction. This does not mean that the exercise of an option to renew can never create a security interest. Just as the exercise of a purchase option changes the transaction at the point of exercise from a true lease to a sale, the exercise of an option to renew may change a transaction from a true lease to a disguised security interest.

For example, suppose that a lease contains an option to renew to the end of economic life, but provides that the price of the renewal will be set at the time the option is exercised. The original transaction is not a disguised security interest, but a true lease.[171] But when the option to renew is exercised, this second transaction creates a security interest, because it is a lease to the end of economic life. Although the language of the Proposed Amendment does not clearly mandate this result, it appears consistent with the overall scheme of the Proposed Amendment, and, I believe, with its intent.[172]

Just as the Proposed Amendment identifies the provisions that will create a security interest, it also identifies some lease provisions that do not alone create a security interest. A transaction will not be found to be a security interest merely because it provides:

> (a) the present value of the consideration the lessee is obligated to pay under the lease is substantially equal to or greater than the fair market value of the goods at the time the lease is entered into,
>
> (b) the lessee assumes risk of loss of the goods, or agrees to pay taxes, insurance, filing, recording or registration fees, or service or maintenance on the goods,
>
> (c) the lessee has an option to renew the lease or to become the owner of the goods,
>
> (d) the lessee has an option to renew the lease for a fixed rent that is equal to or greater than the reasonably predictable fair market rent for the use of the goods for the term of the renewal at the time the option is to be performed, or

171. The original lease term is not to the end of economic life, and the renewal is not for a nominal amount. *See Proposed Amendment*, U.C.C. § 1-201(37)(first a), and (first c), *supra* note 3. According to § 1-201(37)(second d), a renewal for reasonably predictable fair market rent at the time the option is performed is not nominal, and under § 1-201(37)(x)(i), a renewal price determined at the time the option is performed is not nominal.

172. There are two problems in reaching the result presented in the text under the Proposed Amendment. *See infra* text accompanying notes 224–30.

(e) the lessee has the option to become the owner of the goods for a fixed price that is equal to or greater than the reasonably predictable fair market value of the goods at the time the option is to be performed.[173]

These provisions are intended to undercut decisions focusing upon obligations of the lessee under the lease which are not economically inconsistent with the existence of a true lease.[174] Under the Proposed Amendment, obligations that have been considered indicia of ownership under prior case law, such as assumption of the risk of loss or the obligation to pay taxes, will no longer be sufficient alone to support a finding that the lease is a disguised security interest.[175] Similarly, the fact that the lease provides for total payments which equal or exceed the purchase price of the equipment will no longer be sufficient.[176]

a. *Nominal Value*

It is helpful to take another look at the concept of nominal value because it is critical to understanding which options to purchase and renew will create disguised security interests, and which are consistent with the existence of true leases. The Proposed Amendment contains two provisions that aid in determining whether an amount is nominal. First, a lease with an option to renew for a rent, fixed in the original lease agreement, which is equal to or greater than the reasonably predictable fair market rent at the time the option is exercised, does not create a security interest.[177] The term "reasonably predictable" is used to refer to the facts and circumstances at the time the transaction granting the option to renew is entered into.[178] Assume, for example, that the original lease provides an option to renew, and sets a price for that renewal option. If the price set is consistent with the anticipated fair market rent, then there is a true lease. The negative implication of this provision is that a renewal option price that is less than the anticipated fair market rent may create a security interest.[179]

The same standard is applied to an option to purchase. If the option price set in the agreement is equal to or greater than the reasonably predictable fair market value of the goods at the end of the lease term, then the transaction is a true lease.[180] This is consistent with a true nature analysis, which requires that the determination of the residual value be as anticipated by the parties at the time the option price is set.[181]

Whether the option is to purchase or renew, the courts must view the transaction prospectively, determining not whether the option price is equal to the actual fair market value of the residual at the time of exercise, but rather whether it is equal to

173. *Proposed Amendment*, U.C.C. § 1-201(37), *supra* note 3.

174. See *supra* text accompanying notes 115–30 for a discussion of these factors.

175. *See supra* text accompanying notes 120–30.

176. *Proposed Amendment*, U.C.C. § 1-201(37)(second a), *supra* note 3. *See also id.*, Official Comment, ("Subparagraph (a) has no statutory derivative; it states that a full payout lease does not *per se* create a security interest.").

177. *Proposed Amendment*, U.C.C. § 1-201(37)(second d), *supra* note 3.

178. *Proposed Amendment*, U.C.C. § 1-201(37)(y), *supra* note 3.

179. *See Proposed Amendment*, U.C.C. § 1-201(37), *supra* note 3, Official Comment. See *infra* note 184 quoting the Official Comment.

180. *Proposed Amendment*, U.C.C. § 1-201(37)(e), *supra* note 3.

181. *See supra* text accompanying notes 63–66.

the anticipated fair market value at the time the option price is set. This timing avoids the transubstantiation problem that results when a court second-guesses the prediction of the parties by focusing on the actual value of the residual at the time the option is exercised.[182]

The second step is found in the definition of nominal value, which provides that an option price that is not set in the lease, but which the parties agree will be the fair market rent or purchase price determined at the time of the exercise, is not nominal.[183] The comment notes:

> A fixed price purchase option in a lease does not of itself create a security interest. This is particularly true if the fixed price is equal to or greater than the reasonably predictable fair market value of the goods at the time the option is to be performed. A security interest is created only if the option price is nominal and the [obligation for the term of the lease is not subject to termination by the lessee]. *There is a set of purchase options whose fixed price is less than fair market value but greater than nominal that must be determined on the facts of each case to ascertain whether the transaction in which the option is included creates a lease or a security interest.*[184]

b. *Economic Life*

The same prospective view of the transaction is applied to the issue of economic life. A lease to the end of economic life is a security interest,[185] as is an obligation to renew to the end of economic life.[186] The same is true of an option to renew for the remaining economic life for nominal consideration.[187] Remaining economic life is determined as of the time the transaction is entered into.[188] This is the appropriate time for the determination, since an evaluation made at a later point could have the effect of changing a transaction, understood by the parties to be a lease at its initiation, into a security interest, due only to the changed actual value of the leased goods—a factor wholly outside of the control of the parties.

Finally, the Proposed Amendment gives us our first Code definition of present value, requiring that lease payments be discounted to present value at the rate specified by the parties if not manifestly unreasonable, and in other circumstances, by a commercially reasonable rate.[189]

---

182. *See supra* text accompanying notes 63–66, and 106–10.

183. *Proposed Amendment*, U.C.C. § 1-201(37)(x), *supra* note 3.

184. *Proposed Amendment*, U.C.C. § 1-201(37), *supra* note 3, Official Comment (emphasis added). The Comment goes on to state: "It was possible to provide for various other permutations and combinations with respect to option to purchase and renew. . . . This was not done because it would unnecessarily complicate the definition. Further development of this rule is left to the courts." *Id.*

185. *Proposed Amendment*, U.C.C. § 1-201(37)(first a), *supra* note 3. Again, remember that the first prong of this test requires that the obligation not be terminable by the lessee. *Id.*

186. *Proposed Amendment*, U.C.C. § 1-201(37)(first b), *supra* note 3.

187. *Proposed Amendment*, U.C.C. § 1-201(37)(first c), *supra* note 3.

188. *Proposed Amendment*, U.C.C. § 1-201(37)(y), *supra* note 3.

189. *Proposed Amendment*, U.C.C. § 1-201(37)(z), *supra* note 3. *See supra* note 57.

2. *The Problem Transactions Revisited*

It is helpful to go back to the true nature analysis and see how each of the hypothetical problem transactions fares under the Proposed Amendment.[190] This permits a clearer insight into the Amendment's actual operation. First, review the transactions when there are options to buy the leased goods:[191]

a. *The Option to Buy*

(1) *The Mandatory Option*

The mandatory option is a contract term requiring the lessee to exercise the option. Under a true nature analysis, this creates a security interest because the nominal lessee is contractually bound to purchase both the use and the residual, and has no opportunity to return the residual to the lessor. The result is the same under the Proposed Amendment. If the obligation is not terminable by the lessee, and the lessee is obligated to acquire the residual, it is a security interest.[192]

(2) *Optioning Out of the Lease Obligation*

Suppose that by optioning out of the lease obligation, the lessee can purchase the residual for less than the cost of performing the remainder of the lease. The true nature analysis treats this transaction as a security interest, because the lessee who can obtain both use and residual for less than the cost of use alone is effectively a purchaser of the goods. Similarly, under the Proposed Amendment, because the definition of "nominal" includes an option price that is less than the cost of performing under the lease agreement, this provision creates an option to purchase for nominal consideration, which is a security interest.[193]

(3) *Option Price Too Low*

If the option price is less than the anticipated residual value of the goods, then the true nature of this transaction is a security interest, because the nominal lessor is not being fully compensated for ownership of the residual, and must previously have transferred this residual to the lessee in exchange for some portion of the lease payments. The result under the Proposed Amendment may be the same, although the point at which the option price becomes nominal is not altogether clear.

The Proposed Amendment explicitly provides that a nominal price option creates a security interest, and that payment of a price equal to or greater than the reasonably predictable fair market value is *not* a security interest.[194] This creates the negative inference that payment which is less than the reasonably predictable fair market value

190. *See supra* text accompanying notes 53–76.
191. *See supra* text accompanying notes 54–66.
192. *Proposed Amendment*, U.C.C. § 1-201(37)(first b), *supra* note 3.
193. *Proposed Amendment*, U.C.C. § 1-201(37)(first d), and (x)(ii), *supra* note 3.
194. *Proposed Amendment*, U.C.C. § 1-201(37)(first d), and (e), *supra* note 3.

is nominal. But the Official Comment notes that there is a class of option prices that are less than fair market value but are not nominal.[195] As a result, it is unclear under the Proposed Amendment what disparity between the fair market value and the option price will trigger a finding that a security interest exists.[196] Obviously, the greater the disparity, the more likely a finding that the transaction creates a security interest and not a true lease. But the other factors which are properly considered by a court making this determination are not provided by the Proposed Amendment.

(4) *The Right Option Price*

When the lease contains an option price equal to or greater than the reasonably predictable fair market value, we have a true lease for true nature purposes as well as under the Proposed Amendment. The option payment fully compensates the lessor for the ownership of the residual.[197] The Proposed Amendment reaches this result by stating that an option to purchase for a fixed price equal to or greater than the anticipated fair market value does not create a security interest.[198]

(5) *The Nominal Option Price*

Under a true nature determination, a nominal option price creates a disguised security interest only when it is less than the anticipated residual value of the goods. If it is equal to or greater than this residual value, it is not nominal merely because it is a small dollar amount, or because it is small in relation to the value of the goods at the transaction's inception. The same is true under the Proposed Amendment.[199] So long as the price is equal to or greater than the anticipated value of the residual being transferred upon exercise of the option, the option price is not nominal. Even an option price that is less than the reasonably predictable value of the residual is not necessarily a nominal option price under the Proposed Amendment. At some point an option price will be considered nominal when it is sufficiently below the fair market value of the residual.[200] The problem with small option prices which are not nominal under the definition in the Proposed Amendment is that they may indicate a lease to the end of useful life.

b. *Leases to the End of Economic Life*

The second set of hypotheticals addressed leases to the end of useful life, or, as it is referred to in the Proposed Amendment, economic life:[201]

---

195. *Proposed Amendment*, U.C.C. § 1-201(37), *supra* note 3, Official Comment. *See supra* text at note 184 quoting the Official Comment.

196. See *infra* text accompanying notes 218–30 further examining this issue.

197. *Proposed Amendment*, U.C.C. § 1-201(37)(e), *supra* note 3.

198. *Id.*

199. *Proposed Amendment*, U.C.C. § 1-201(37)(second a), (e), and (y), *supra* note 3.

200. *Proposed Amendment*, U.C.C. § 1-201(37), *supra* note 3, Official Comment. *See supra* text accompanying note 184 quoting the Official Comment.

201. *See supra* text accompanying notes 67–72.

(1) *Substantial Residual Value*

When there is a substantial residual value at the end of the initial lease term, the transaction is a true lease under the true nature analysis, so long as the original lease does not contain an option to renew for nominal consideration. This is also a true lease under the Proposed Amendment.[202]

(2) *Lease to the End of Economic Life*

Although this Article has posited the possibility of a true lease to the end of useful life, when the lessee assumes the risk that useful life will be greater than anticipated, with the residual remaining the property of the lessor, it has also recognized the inability to distinguish it from a disguised security interest when there is in fact no meaningful residual. The Proposed Amendment opts for a bright-line test, and does not recognize true leases to the end of economic life.[203] Because the Proposed Amendment requires that the determination of remaining economic life be made as of the time that the lease transaction is entered into,[204] it leaves unresolved the question whether an attempt to create a true lease by documenting an optimistic economic life will be enforceable.[205]

(3) *Successive Transactions in the Same Goods*

An example of successive transactions in the same goods is a lease of goods with a two year anticipated life to different lessees for successive one year terms. When the first lease is entered into, it is not a security agreement but a true lease. But the second lease is a security interest under the true nature analysis, because there is no meaningful residual to return to the lessor. The Proposed Amendment also finds that the second lease is a security interest, because the original lease term is to the end of economic life.[206] Presumably, filing would be required at the beginning of the second lease, if the interest of the lessor in the goods is to be protected during the second lease transaction.

---

202. *Proposed Amendment*, U.C.C. § 1-201(37)(first a), *supra* note 3.

203. *Proposed Amendment*, U.C.C. § 1-201(37)(first a), *supra* note 3. *See also id.*,U.C.C. § 1-201(37)(first b).

204. *Proposed Amendment*, U.C.C. § 1-201(37)(y), *supra* note 3 (definitions of "reasonably predictable" and "remaining economic life").

205. *See supra* text accompanying note 72. I do not argue for the protection of a sham transaction analogous to Appleway Leasing, Inc. v. Wilken, 39 Or. App. 43, 591 P.2d 382 (1979), discussed *supra* text accompanying notes 111–12. Under the true nature analysis, a court could certainly find that the anticipated residual set by the parties did not reflect a reasonably predictable value, as required by the Proposed Amendment, and hold that the transaction created a security interest. The same may be true of an unreasonable estimate of economic life. But while the Proposed Amendment requires that the residual be the "reasonably predictable fair market" rent or value, *Proposed Amendment*, U.C.C. § 1-201(37)(second d), and (e), *supra* note 3, it does not require that the remaining economic life be "reasonably predictable," but only that it be determined prospectively from the inception of the transaction. *Proposed Amendment*, U.C.C. § 1-201(37)(y), *supra* note 3. Thus, there is at least a technical argument that an unduly optimistic economic life may be enforceable under the Proposed Amendment. At a less technical level, however, when the parties agree that there may realistically be a residual value that cannot be determined, or an economic life beyond that anticipated, and intend that any residual, whatever its value, remain the property of the lessor after the agreement is terminated, in theory, this should sustain a finding of a true lease.

206. *Proposed Amendment*, U.C.C. § 1-201(37)(first a), *supra* note 3.

(4) *Option to Renew to the End of Economic Life*

An option to renew to the end of economic life is the chameleon lease, which is a true lease when the original transaction is entered into, but which becomes a security interest when the option to renew is exercised. It becomes a security interest at that point because it is a lease to the end of useful life.[207] It is more fully explored in the third category, leases with options to renew.

c. *Options to Renew*

(1) *The Mandatory Option to Renew*

Under the Proposed Amendment, a lease containing a mandatory option to renew creates a security interest if the renewal period is for the remaining economic life of the goods.[208] Otherwise, there is no security interest based solely upon a contract term mandating a renewal.

(2) *Option to Renew for Less Than Anticipated Value*

Under the Proposed Amendment, if the renewal price is less than the anticipated use value of the goods for the period of renewal, there may be a security interest, but only when the amount paid for the renewal option is sufficiently low to trigger a finding that it is nominal. The Proposed Amendment provides that an option to renew for no consideration or nominal consideration creates a security interest, but only if the renewal is to the end of economic life.[209] Again, there is no guidance in the text of the Proposed Amendment for determining the point at which this amount will be deemed nominal, but the Official Comment raises the possibility that an amount less than the fair market value may not be considered nominal, and therefore would not create a security interest.[210]

It is essential to remember that nominal price only creates a security interest under the Proposed Amendment when the renewal is to the end of economic life. Likewise, under the true nature theory, a renewal option would create a security interest only when the renewal is also to the end of economic life. This is true regardless of the price of the renewal option. If there is a meaningful residual at the end of the renewal period which returns to the lessor, the true nature of the transaction cannot be a security interest, no matter what disparity exists between the anticipated value of the renewal right and the option price.[211]

---

207. *Id.* This presumes, of course, that the obligation of the lessee is not terminable, satisfying the first requirement of the test. On the nature of a chameleon lease, see *supra* note 170 and accompanying text. There is, of course, the argument that the subsequent renewal lease cannot be a security interest because it does not fall under the literal language of the amendment that "the original term of the lease is equal to or greater than the remaining economic life of the goods." *Proposed Amendment*, U.C.C. § 1-201(37)(first a), *supra* note 3. This issue is discussed in greater detail in *infra* text accompanying notes 218–230.

208. *Proposed Amendment*, U.C.C. § 1-201(37)(first b), *supra* note 3.

209. *Proposed Amendment*, U.C.C. § 1-201(37)(first c), *supra* note 3.

210. *Proposed Amendment*, U.C.C. § 1-201(37), *supra* note 3, Official Comment; see *supra* text at note 184 quoting the Official Comment. Although the comment refers specifically to options to purchase, the context makes clear that this issue would also apply to an option to renew.

211. This problem is more fully explored *supra* text accompanying notes 73–76.

(3) *Option to Renew for the Anticipated Value*

If the renewal price is equal to or greater than the fair market rent for the goods, then the Proposed Amendment does not consider this a security interest based upon the price, because the renewal price is not nominal.[212] But it does raise the possibility that the transaction is a security interest if the renewal period is to the end of economic life. So long as this renewal is not to the end of economic life, both the original lease and the renewal are true leases under the Proposed Amendment. This is consistent with the result under true nature theory. Regardless of the renewal price, if there is a meaningful residual returned to the lessor at the end of the renewal term, the transaction is a true lease. But the Amendment does not answer the question whether the renewal to the end of economic life might result in a recharacterization, so that, while the original transaction remains a true lease, the renewal becomes a security interest as a lease to the end of economic life.

(4) *Option to Renew to the End of Economic Life*

If the renewal option passes the nominal value test under the Proposed Amendment, then a security interest can be created only if the renewal is to the end of economic life.[213] If the renewal is mandatory and to the end of economic life, then this creates a security interest from the inception of the transaction.[214] If the renewal is optional, to the end of economic life, and for nominal consideration, this creates a security interest from the inception.[215] But if the renewal is optional, to the end of economic life, but not for nominal consideration, the Proposed Amendment leaves us with an interesting problem. The original lease would not be a security interest, but the renewal creates one, as a lease to the end of economic life.[216] Again, this is the chameleon transaction,[217] which would require a filing to protect the interest of the lessor from the point when the option to renew is exercised.

C. *Some Unanswered Questions Under the Proposed Amendment*

One issue not fully clarified by the Proposed Amendment is the interaction between option prices and leases to the end of economic life.[218] What result will occur if the parties set an option price that is equal to a minimal residual value, because the lease is essentially one for the economic life of the transaction? If we focus upon the option price, the transaction will not be considered a security interest, because the Proposed Amendment specifies that an option price equal to or greater

212. *Proposed Amendment*, U.C.C. § 1-201(37)(second d), *supra* note 3.

213. *Proposed Amendment*, U.C.C. § 1-201(37)(first a), and (y), *supra* note 3.

214. *Proposed Amendment*, U.C.C. § 1-201(37)(first b), *supra* note 3.

215. *Proposed Amendment*, U.C.C. § 1-201(37)(first c), *supra* note 3.

216. Although the Proposed Amendment refers to "the original term of the lease" as being equal to or greater than the remaining economic life, presumably this provision would also apply to a renewal, once exercised, which becomes a lease to the end of economic life. *Proposed Amendment*, U.C.C. § 1-201(37)(first a), *supra* note 3. See *infra* text accompanying notes 218–30 for a discussion of this issue.

217. *See supra* note 170.

218. See *supra* note 114 for a discussion of this issue.

than anticipated residual value is not a security interest.[219] But if we view the transaction as a lease to the end of economic life, it will be considered a security interest.[220] Which of these views should prevail?

It is appropriate to consider this transaction a security interest. In fact, a case cited by the Official Comment reached this result.[221] Since all meaningful residual is being transferred to the lessee for the lease payments, plus a small amount for the residual upon exercise of the option, this transaction should be considered primarily a lease to the end of economic life. Only when the value of the residual represents a meaningful interest to the lessor should the transaction be viewed as a true lease. Arguably, this should include those cases in which the parties understand that the residual value is not known, but they nevertheless agree that the residual will remain the property of the lessor, unless payment equal to the then determined fair market value is made. But when both parties agree and understand that the residual has no anticipated value to the lessor, and the lessor intends for that value to become the property of the lessee, the transaction should not be saved from a finding that it is a security interest by a lease provision permitting transfer of the residual for an amount equal to the anticipated residual value, or for the fair market value to be determined at the point of exercise.

The second unresolved issue is the absence of any guidance in the Proposed Amendment describing when the amount of an option to buy or renew is nominal. An option payment that is less than the anticipated fair market value is not necessarily nominal under the Proposed Amendment. The troubling language in the Official Comment, which notes that there is a category of options whose price is less than fair market value but greater than nominal,[222] pinpoints this problem, but offers little guidance. The comment merely provides that these must be determined "on the facts of each case."[223] Given what the courts have done when left with this slim guidance under the current version of Section 1-201(37), this gap in the definition of nominal value could create the same problems which the Proposed Amendment is intended to resolve.

Remember that nominal value is only relevant when there is an option to purchase the goods, or to renew the lease to the end of economic life. In other words, we need a definition of nominal that will address a transfer of all remaining residual value, and recognize that transfer of this value for sufficient payment does not make the initial transaction a disguised security interest. For example, it would be preferable to provide that an option payment less than the anticipated fair market rent or value is nominal when it would not induce a reasonable lessor to transfer the residual outside of the context of the lease agreement. If no reasonable lessor would transfer the entire residual in exchange for the option payment, absent a prior lease

---

219. *Proposed Amendment*, U.C.C. § 1-201(37)(e), *supra* note 3.

220. *Proposed Amendment*, U.C.C. § 1-201(37)(first a), *supra* note 3.

221. *In re* Celeryvale, 44 Bankr. 1007 (Bankr. E.D. Tenn. 1984), discussed *supra* text accompanying notes 113–14, which is cited with approval in the Official Comment to *Proposed Amendment*, U.C.C. § 1-201(37), *supra* note 3.

222. *Proposed Amendment*, U.C.C. § 1-201(37), *supra* note 3, Official Comment; see *supra* text at note 184 quoting the Official Comment.

223. *Id.*

relationship between the lessor and lessee, then the option payment is not compensating the lessor for the value of the residual, but is completing payment, and the transaction is a security interest, and was from the inception. This test, or any similar test which gives the courts guidance as to the operation of the section, is better than the "other facts" guidance offered by the Official Comment.

The third difficulty is the question whether the Proposed Amendment intends to prevent the possibility of a chameleon lease. It is unclear whether the Proposed Amendment contemplates that a transaction will be characterized from the inception, and then never change, regardless of the effect of an option to renew, or whether an option to renew may properly result in a new character, which does not change the nature of the original transaction. This Article has assumed that the chameleon lease still exists under the Proposed Amendment, so that a renewal to the end of economic life may result in a recharacterization of the transaction from the point when the option is exercised, but not from the inception of the transaction.[224] But there are two difficulties in reaching this result.

First, the literal language of the Proposed Amendment states that a security interest exists when "the original term of the lease is equal to or greater than the remaining economic life of the goods."[225] If this provision is applied narrowly, then the initial transaction is a true lease, and no renewal can be anything but a true lease, so long as the original term is not to the end of economic life. This would include a renewal to the end of economic life, as long as the renewal option price is not nominal and the renewal is not mandatory.[226]

However, it is also possible to read this provision to mean simply that the *original transaction* is a security interest when the period is to the end of economic life, or when it contains a mandatory option to renew to the end of economic life, or an option to renew to the end of economic life for nominal consideration. These provisions do not answer the question whether a renewal to the end of economic life can change a transaction that was previously a true lease into a security interest, not from the inception but only from the point of exercise. The analogy of the purchase option makes this argument a compelling one.[227] We know that, upon exercise of a purchase option, the transaction is no longer a lease but a sale, but the exercise of this option does not normally mean that the original transaction was always a disguised security interest.[228] There is no reason why an option to renew should not receive comparable treatment.

The second impediment to this argument is the language of Official Comment (j) to Section 2A-103. That comment implies, through the use of a thirty-six month lease hypothetical, that the words "original term" mean literally the first term, regardless

224. *See supra* text accompanying notes 170–73.

225. *Proposed Amendment*, U.C.C. § 1-201(37)(first a), *supra* note 3.

226. *Cf. Proposed Amendment*, U.C.C. § 1-201(37)(first b), and (first c), *supra* note 3.

227. *See supra* text following note 170.

228. The original transaction is only a disguised security interest when the option to purchase is mandatory, *Proposed Amendment*, U.C.C. § 1-201(37)(first a), *supra* note 3, or when the option to purchase is for no or nominal consideration. *Proposed Amendment*, U.C.C. § 1-201(37)(first d), *supra* note 3.

of the effect of subsequent renewals.[229] On the other hand, the same comment contains language supporting the position that a chameleon transaction is still possible under the Proposed Amendment. The comment states: "However, with each renewal of the lease the facts and circumstances at the time of each renewal must be examined to determine if that conclusion remains accurate, *as it is possible that a transaction that first creates a lease, later creates a security interest.*"[230]

This comment is strong evidence of the continued viability of a chameleon lease, with the change in character occurring after the exercise of a renewal option as well as a sale option. On balance, it is consistent with the intent of the Proposed Amendment to conclude that a renewal to the end of economic life may create a security interest from the point of exercise, notwithstanding the fact that the "original term of the lease" is not literally to the end of economic life, but the renewal period is.

IV. CONCLUSION

This Article began with the premise that there is a distinction between a sale, a lease, and a security interest, and that it is essential for the participants to these transactions to ascertain in advance how a court will treat their transactions. It posits the existence of a true nature, which, when pinpointed, permits a court and the participants to differentiate between security interests and leases by examining the economic allocation resulting from the contract between the parties. Recognizing that not every transaction has a true nature which is easily pinpointed, it suggests a bright-line test which results in consistent treatment, but only in those cases that cannot otherwised be distinguished.

Although the Proposed Amendment offers some potential for interpretive problems,[231] the new definition of "security interest" focuses attention where it should be, upon the economic allocation between lessor and lessee effected by the transaction, viewed as of the time it is entered into. It does not rely upon the intent of the parties as expressed in their documents, nor upon the specific obligations of the lessee under the lease. It views the transaction as a whole, interpreting the nature of the transaction according to the same issues which motivate the parties to enter into these transactions. While it does not provide an answer to every conceivable transaction, it is a grand improvement over the current guidelines provided by the U.C.C., and it offers a philosophical viewpoint that should guide courts in their application of the law to transactions for which no clear answer is provided.

---

229. *Article 2A*, *supra* note 3, § 2A-103, Official Comment (j).

230. *Id.* (emphasis added).

231. *See supra* text accompanying notes 218–30. An additional potential interpretive problem arises when one considers a lease wherein the obligation of the lessee is terminable, but only upon payment of liquidated damages specified in the lease agreement. Under the strict application of the rule, a terminable obligation cannot be a security interest, and yet one can imagine an amount that would be equivalent to the payment obligation under the lease, leaving the lessee with the residual economic value of the goods. Under the second part of the test, this would qualify as a security interest, because it is an agreement wherein the lessee is bound to become the owner of the goods, but because it fails the literal language of the first part, it could be considered a lease of goods which only later is the subject of a sale.

The Proposed Amendment is an effective and timely reminder to courts addressing leasing transactions that a laundry list of prohibited contract terms will not ultimately help to distinguish security interests from leases. The drafters of these documents are simply too clever, and the issue arises again and again. Only by concentrating upon the economic transfer represented by the goods can the true nature of these transactions be identified, and their categorization should now be possible with consistent and reliable results. With the adoption of this Proposed Amendment, the parties and the courts will, for the first time, have a sound basis upon which to judge the nature of their contractual agreements.